

HIRE - PURCHASE ACCOUNTS AND FINANCE

By

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LONDON:
GEE & CO. (PUBLISHERS) LTD.
KIRBY STREET, E.C.1

1930

PRINTED IN GREAT BRITAIN

PREFACE

ACCOUNTANCY problems arising out of the acquisition of goods under the hire-purchase system have been fully considered in numerous works on advanced accounting, but the attention which has hitherto been given to the accounts of retailers selling goods on hire-purchase terms has scarcely been commensurate with the important place which hire-purchase has lately assumed in commerce. In this volume I have therefore endeavoured to explain the accountancy problems which face retailers and their professional advisers, and to set out a system of accounts which is adaptable to the requirements of traders of all classes. Closely allied to such problems are questions of financial policy and the suitable presentation of accounts intended for public information, some of which are as yet not generally understood.

When turning their activities to the opportunities offered by the hire-purchase system, traders sometimes endeavour to graft the records relating to the new form of selling on to their existing books of account, without fully appreciating that if the system is to be successfully exploited it must be scientifically conducted. In the absence of a lead to adopt a standard form of treatment in accounts such as has been given in America by bankers and finance companies, there have arisen in England various methods of treatment which, though possessing certain features in common, yet differ in points of practical detail. It has thus been impossible within the scope of this volume to cover the peculiarities of all hire-purchase businesses. The salient points are explained and contrasted, and when no definite conclusions are stated, it is because I have thought it unwise to appear dogmatic.

The long period of credit which is becoming so usual in England leads to the accumulation of unpaid instalments in a hire-purchase business which are out of

proportion to the debts of an ordinary credit business with a similar turnover. The necessity for suitable bookkeeping records, which will summarise the trading operations in a manageable form and facilitate adequate supervision of the collection of instalments, cannot therefore be too strongly emphasised, and for this purpose the "Running Summary of Instalments Falling Due," which is described in Chapter III, is indispensable.

I am indebted to the Hire Traders' Protection Association for permission to reproduce the scheme which they have recently concluded with the Board of Inland Revenue relating to assessment of the profits of hire-purchase traders. The arrangement represents the successful termination of efforts which the Association have made for a number of years past to secure official recognition of the special nature of hire-purchase trading. I also take this opportunity of expressing my thanks to Mr. J. A. Hare, A.C.A., for many valuable suggestions.

CHAS. W. ASTON.

London, 1930.

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CHAPTER I

GENERAL REMARKS

INTRODUCTORY REMARKS.

GROWTH OF THE HIRE-PURCHASE SYSTEM.

THE PUBLIC POINT OF VIEW.

THE TRADER'S POINT OF VIEW.

EFFECT ON MANUFACTURERS.

I.—GENERAL REMARKS

Introductory Remarks

THE prosperity of many modern retail distributing businesses has been built upon the popularity of the hire-purchase system, which promises to revolutionise both the commercial and private outlooks of the community. Hire-purchase has been known in England for very many years, but for a long time supporters of the system had to contend with prejudices arising from a conviction that it was undesirable, and even unbecoming from a social point of view, to take advantage of the facilities which it afforded. The propriety of trading on borrowed money was never questioned; in fact the necessity for incurring debts for business purposes was regarded as obvious; yet when a person furnished his home on credit he did so at the risk of endangering his social status, and consequently had to proceed under the cloak of secrecy.

The reduced purchasing power of the people following the war has been partly instrumental in overcoming social objections to the system, while judicious advertising, backed by influential views which have been expressed in various quarters, has done much to bring about a revision of the popular attitude. It is surprising, however, that there is not more discussion, by well-informed observers, of the broader and more lasting influences of the system. Probably most public utterances on the subject emanate from the heads of retail organisations, who naturally favour its extension. Then there is a type of journalism intended to appeal to the popular taste which lauds the system as the panacea of all industrial and individual woes, but ignores the dangers which, as even supporters of the system have to admit, exist in

certain cases. On the other hand there is the pessimist who sees ruin facing the private individual who purchases anything for which he cannot pay prompt cash, and bad debts accumulating to swamp the business man who ventures to employ the system as a means of selling his goods. Between these two extremes there are few attempts to make an impartial examination of the merits of the system. Its effect has to be considered on customers, retailers, manufacturers and the country in general. To customers there are many attractive features, as they are enabled substantially to increase their standard of living but there are also temptations to be avoided. To retailers the system may appear to provide a solution of the difficulty of increasing turnover, but, as will be shown in the course of this book, the cure is not perfect. To manufacturers, the system, although only of indirect interest, yet has an important influence in their business, and its progress deserves their careful attention. To the country in general it is one of the most striking developments of the present day and is bound to exercise lasting effects on the future prosperity of the community. Its widespread popularity is demonstrated by the statement of a well-informed observer that practically one in every two families in England acquires something each year on hire-purchase terms.

As this book is concerned chiefly with financial aspects of the system, it is not intended to do more than indicate briefly the conditions under which hire-purchase trading has developed and the lines along which economic enquiries into its operations might be pursued.

Growth of the Hire-purchase System

For thirty years or more before the present era of intensive hire-purchase trading, furniture, pianos, clothing

and a number of other articles could be obtained by hire-purchase, but the exact terms of sale were often wrapped in mystery or beyond the comprehension of the customer. The methods employed by retailers to ensure payment were sometimes far from praiseworthy and it is common knowledge that the less reputable firms, which operated chiefly in the poorer districts of large cities, took advantage of their position in dealing with customers. They did not hesitate, as soon as one or two instalments of a debt fell into arrear, to recover, in many cases, the whole of the goods which had been sold. As a result of these circumstances, and the fact that more often than not the prices paid for articles did not compare favourably with cash prices, only persons of very limited means were driven to resort to the system.

When the post-war boom was followed by a period of depression, retailers found it difficult to maintain their turnover, and began to see the possibility of stimulating demand by means of a system of purchase on easy terms which would be fair to consumers without depriving traders of their rights over goods sold. Thus, by persistent advertising and frank disclosure of the terms of sale, the hire-purchase system as we know it to-day was brought into prominence. Increasing competition has resulted not only in abolishing malpractices but has led to the inclusion of clauses in the agreements with customers which operate considerably to their advantage; particularly is this so in the case of the retail furniture trade. In the event of cancellation of an agreement, all reputable firms now allow retention of goods to the value of instalments paid. In addition to the well-known offer to lay linos and carpets without charge, retailers advertise free delivery of goods, free tuning of pianos, free life and fire insurance policies during the term of the agreement, and promises of indulgence during illness or other unforeseen

events which may upset plans for providing payments out of income. Some firms offer to pay the railway fares and expenses of prospective customers from the country to their stores in the large cities. Others have abolished the necessity for substantial initial deposits, extended the period of credit to as much as four years, dispensed with the necessity for giving references, and abolished interest charges on the debts. Completion of transactions with customers is speedily effected and their personal susceptibilities are considered in the promise of unobtrusive delivery.

With the increasing popularity gained by the system there has arisen a wide extension of its application. It is possible to get a house completely furnished by hire-purchase, but of particular importance in its effects on social and commercial life is the spread of hire-purchase to articles usually classed as luxuries, such as motor-cars, jewellery, musical instruments, gramophones, wireless sets, cameras, books, and fur coats. Whereas formerly it was confined principally to household furniture and necessities, there are now few articles which cannot be obtained under the system. The result has been a noticeable rise in the standard of living and a great impetus to the luxury trades of the country.

The latest extension of the possibilities of the system is revealed in a press report which declares that even funerals may be ordered and paid for by this method. It is now possible for the departed to be buried with every conventional and religious observance—states the report—provided the relatives are prepared to pay a small sum weekly to the undertaker.

Apparently there is no end to the ramifications of the system, and one naturally hesitates before making speculations as to the future.

An enquiry into the economic soundness of hire-

purchase is beyond the scope of this volume, and it is only desired to direct attention to one matter which does not appear to receive sufficient recognition. The success which has attended the purchase of house property through the medium of building societies is sometimes advanced as a reason why payment by instalments should be extended to other spheres. Apart from the similarity in the mode of payment, there is no relation between the hire-purchase system and the purchase of a house through a building society. The house is purchased outright and is then mortgaged to the society as security for the unpaid portion of the price—quite a different procedure from that followed in hire-purchase. House property usually has a prospective life far in excess of the period for which mortgages are granted, and its realisable value can generally be estimated with a fair degree of accuracy. Its superiority over movable chattels as security for loans is therefore apparent.

A further distinction between the activities of building societies and hire-purchase traders is that the funds of building societies available for investment in house mortgages are provided by the savings of members, whereas the source of hire-purchase credit can usually be traced to the banks which advance loans to traders against the unpaid instalments. It will thus be seen that while the building societies do not increase the amount of money available for investment but merely serve as distributing centres, the hire-purchase system results in the creation of additional credit—tantamount to a form of inflation, though probably of small effect in comparison with the total wealth of the country.

The Public Point of View

From the point of view of the public which avails itself

of the facilities afforded by hire-purchase, the system has advantages worthy of consideration. It should be borne in mind, however, that the very easiness of the system lays it open to abuse by people who are unable to resist the impulse to purchase things which they cannot afford.

Amongst the advantages, one of undoubted value and now common to practically all furniture dealers, is the offer of a free life insurance policy to operate during the term of the hire-purchase agreement. The policy provides for cessation of a customer's liability under an agreement in the event of his decease, or where no life insurance policy is actually issued, the agreement usually provides that in the event of the hirer's death no further instalments of the debt shall become payable and the whole of the goods covered by the agreement shall fall into the estate of the deceased. A clause of this nature appears in the specimen agreement in Chapter II. Where an agreement is obtained which cites a man and his wife as joint hirers, apparently the above clause would be inoperative except on the death of both.

A second advantage to the purchaser is that he is able to obtain immediate use of his purchase whilst paying for it out of income. Investments need not be disturbed by the necessity of finding ready money. Often it may be found excellent economy to purchase under the system out of the income of specific investments which yield regular dividends. It is obvious, however, that a payment-out-of-income system should be strictly adhered to if practical advantage is to be gained. Overbuying with consequent encroachment on capital may lead to dire results.

When judiciously employed the system may act as a strong incentive to thrift, and an interesting example of a scheme designed to that end is afforded by an experiment which has been introduced by the City of Birming-

ham. Some of the Corporation Housing Estate maisonnettes have been furnished and tenants are being allowed to purchase the furniture by hire-purchase instalments spread over three years. The tenants are required, as part of the tenancy conditions, to agree to acquire within a period of three years, additional furniture to furnish an ordinary house. There is thus a direct inducement to such tenants to improve their standard of living and to become possessors of desirable homes. When thus employed the system has manifestly much to recommend it.

The period of the agreement with the retail house should have due consideration by the customer before he commits himself. Many people are not so fortunately placed that they are able to forecast their resources three and four years ahead, and a prudent policy should be adopted by a prospective purchaser when committing himself to definite payments over a long period.

A purchaser with a practical eye on his domestic economies may employ the system to his personal advantage and rarely bring it into abuse, but the facilities afforded are, of course, available to the practical and unpractical alike.

The Trader's Point of View

The growth of hire-purchase trading emphasises the importance of the subject to retailers. Some have seized on hire-purchase methods as a means of advertising their business, and as a quick and easy way of increasing turnover. Competitors of less financial resource have been forced to follow in their footsteps in order to maintain a market for their wares. Offers and counter-offers to the public are made almost daily, and there seems to be a danger that advertising costs are becoming excessive.

Sound hire-purchase trading can only be conducted

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with full cognizance of the risks involved, and experience has shown that the following principles should be observed in managing the business :—

- (a) The initial payment under the agreement should be fixed so as to secure to the customer a substantial interest in the article, thereby creating an incentive to pay the remaining instalments. For instance, if a piano may be obtained by an initial payment of £2 and further monthly payments of £2, the purchaser who is aware that the ordinary hire of a piano is, say, £5 a month, may be tempted to take the instrument on hire-purchase terms and exercise his option under the agreement by returning the piano at the end of one month and refusing to pay further instalments. He will thus have gained the advantage of piano-hire for £3 less for one month than it would cost him on ordinary terms of hire.
- (b) The amount of each instalment should be so regulated that the value of the customer's interest in the purchase increases at a proportionately greater rate than that at which the article depreciates, otherwise the security for the payment of the later instalments will have diminished. Thus, if an article cost £72 to be paid for in 36 monthly instalments of £2, and depreciation is at the high rate of 50 per cent. per annum, it is obvious that in the third year no security will be available to the trader in respect of £24.
- (c) Articles sold on hire-purchase terms should be useful and durable; useful because a person is less likely to default in paying instalments on such an article than on a luxury which may quickly lose its appeal; and durable in order that the security for payment of the instalments may be maintained.

- (d) Articles should have a good second-hand or re-marketable value, for while in practice it is rarely necessary for the trader to regain possession of the goods, he should always be able to re-sell at a satisfactory price if the occasion arises. Such goods as bicycles, clothing, wireless components, china, and glass rarely possess this feature. Consequently the security afforded by them is diminished almost as soon as the purchaser obtains possession. A correspondingly larger initial payment should therefore be required.

An excellent example of the observance of the first principle is afforded by the Society of Motor Manufacturers and Traders, Ltd., which recommends to its members that an initial first payment of 25 per cent. should be required in the case of motor-cars sold on hire-purchase terms. Observance of the rule is by no means general among retailers, however, and they sometimes seek to guard against abuse by stipulating that when goods are returned such further sum shall be paid by the customer as will amount with the instalments already paid to a certain percentage of the value of the goods. This course sometimes leads to difficulty in recovering the amount from the customer and is not so satisfactory as insistence upon an adequate initial deposit.

These few principles serve to show the discrimination which should be exercised by a trader in forming his selling policy, but in other directions too, care is needed if trading is to be conducted on a sound basis. In businesses which sell both for cash and on hire-purchase terms it is a common practice to fix hire-purchase prices by adding interest to the cash prices at which the goods are marked for sale; in some cases, however, goods are marked at hire-purchase prices and a discount is allowed to cash purchasers. The difference in price is frequently regarded

as covering only interest on the unpaid instalments for the period of credit, but reflection will show that a trader is involved in other overhead expenses such as the cost of collecting overdue instalments, extra bookkeeping, office equipment and management, bad debts, increased advertising, and the cost of free life insurance offers. A few firms make little or no distinction between cash and hire-purchase prices, but nevertheless the overhead expenses exist, and if the loading on hire-purchase prices is not sufficient to cover them the effect is that cash customers are helping to pay for the expenses of the hire-purchase trading.

There is much confusion of thought as to the rate of interest which is charged for hire-purchase accommodation and a study of the following example will help to make the position clear :—

	£	s	d
Amount of Sale	100	0	0
Payable by four quarterly instalments of	26	10	0
Amount of Interest	6	0	0

The debt is liquidated in the following manner :—

	£	s	d	£	s	d
Amount of Sale	100	0	0			
First Instalment payable on signing contract	26	10	0			
	<u>£73</u>	10	0			
Interest for three months ..	2	19	3	2	19	3
	<u>£76</u>	9	3			
Second Instalment payable at the end of three months	26	10	0			
	<u>£49</u>	19	3			
Interest for three months ..	2	0	3	2	0	3
Forward.. ..	<u>£51</u>	19	6	4	19	6

	£	s.	d.	£	s.	d.
Forward.. ..	51	19	6	4	19	6
Third Instalment payable at the end of six months	26	10	0			
	<hr/>					
	£25	9	6			
Interest for three months ..	1	0	6	1	0	6
	<hr/>					
	£26	10	0			
Fourth Instalment payable at the end of nine months	26	10	0			
				<hr/>		
				£6 0 0		
				<hr/>		

It will be noticed that although the amount of interest charged is only 6 per cent. on the original sale of £100, the effective rate calculated on the amounts outstanding at the commencement of each quarter is approximately 16 per cent. per annum. The causes of this disparity between the nominal and effective rates are firstly, that the sale is payable by four quarterly instalments which become due at the commencement of each quarter, and the debt is therefore liquidated in nine months; secondly, the amount of the debt is reduced as payments are made, and the sum on which interest is calculated is much less than the amount of the sale. Quarterly payments have been adopted as an example although they have the effect of accentuating the differences between the nominal and effective rates of interest. When dealing with sales which are to be paid by monthly instalments, a close approximation to the effective rate can be made by deducting one instalment from the cash sale price and dividing half the balance into the amount of interest for

one year. The result is sufficiently accurate for ordinary purposes. Thus :—

CASH SALE PRICE	..	..	..	£100	0	0
Payable by 36 monthly instal-						
ments of	..	..	..	2	19	9
Balance of debt after payment of						
first instalment	..	..	..	97	0	3
Interest charged	..	..	..	7	11	0
Interest for one year	..	..	..	2	10	4

$$\text{Effective rate of interest (approximately)} = \frac{2.516 \times 100}{\frac{97.0125}{2}} = 5.18\%$$

CASH SALE PRICE	..	..	..	£50	0	0
Payable by 12 monthly instal-						
ments of	..	..	..	4	10	0
Balance of debt after payment of						
first instalment	..	..	..	45	10	0
Interest charged	..	..	..	4	0	0
Interest for one year	..	..	..	4	0	0

$$\text{Effective rate of interest (approximately)} = \frac{4.00 \times 100}{\frac{45.5}{2}} = 17.58\%$$

In the first case it might be thought that the rate of interest was $2\frac{1}{2}$ per cent. per annum for three years on the cash sale price and in the second 8 per cent. per annum on the cash sale price. Actually, it will be seen that the effective rate is rather more than twice the nominal rate in each instance.

While the rate of interest charged for hire-purchase accommodation is thus greater than appears at first sight, it is very doubtful whether it is adequate to cover the heavy expenses incidental to the business. It is estimated that in the United States an average nominal charge of

from 10 to 20 per cent. is made on cash prices to meet hire-purchase facilities, and it is instructive to compare these terms with the charges made by firms in England as shown in the following table compiled from a number of representative advertisements.

Nature of Article	Cash Price	Hire-purchase Terms	Total Hire-purchase Price	Interest Charge	Effective rate of Int. (app.)
	£ s d		£ s d	£ s d	%
Suite of Furniture	21 0 0	36 mthly instalments of 12s.	21 12 0	12 0	2
Do.	8 19 6	36 mthly instalments of 5s. 4d.	9 12 0	12 6	5
Do.	19 19 0	36 mthly instalments of 11s. 11d.	21 9 0	1 10 0	5
Do.	20 0 0	Deposit of £2 and 36 mthly instalments of 10s. 9d.	21 7 0	1 7 0	5
Piano ..	25 0 0	Deposit of 50s. and 24 mthly instalments of 20s.	26 10 0	1 10 0.	6.66
Portable Gramophone	7 0 0	12 mthly instalments of 12s. 3d.	7 7 0	7 0	11
Furs ..	13 2 6	12 mthly instalments of £1 2s. 11d.	13 15 0	12 6	10.4
Motor Cycle	39 12 0	12 mthly instalments of £3 9s. 4d. plus insurance	41 12 0	2 0 0	11

Nature of Article	Cash Price	Hire-purchase Terms	Total Hire-purchase Price	Interest Charge	Effective rate of Int. (app.)
Cycle ..	£ s. d. 5 19 6	12 mthly instalments of 10s. 6d.	£ s. d. 6 6 0	£ s. d. 6 6 6	% 12
Field Glasses	1 13 6	Deposit of 3s. 6d. and 17 mthly instalments of 2s.	1 17 6	4 0	18
Radio Set	22 0 0	12 mthly instalments of 41s.	24 12 0	2 12 0	26
Do.	22 18 6	12 mthly instalments of 40s.	24 0 0	1 1 6	10
Wrist Watch	2 4 6	10 mthly instalments of 5s.	2 10 0	5 6	35
Tennis Racquet	1 1 0	8 mthly instalments of 3s.	1 3 6	2 6	42
Carpet ..	4 4 0	8mthly instalments of 12s.	4 16 0	12 0	48

Although the cost of running the system is important, there are other questions deserving consideration which can only be answered by careful observation and compilation of statistics. For example, hire-purchase organisations which also conduct ready money and short credit account business find that the one class of trade influences the other. Opinions differ as to the precise effect. Some take the view that further opportunities for sales are given when customers visit a store at intervals in order to pay instalments. The other view is that a customer

whose instalments are in arrear will avoid the store when making cash purchases. An authoritative opinion as to the tendencies of trade in these directions would be of value to a retailer contemplating the adoption of hire-purchase selling to supplement his existing business.

Effect on Manufacturers

It is not unusual to find manufacturers who sell direct on hire-purchase terms and there may be instanced the makers of certain accountancy and bookkeeping machines, agricultural machinery and expensive engineering machines. It is probable, however, that the volume of such sales represents but a small proportion of the total hire-purchase business and that the chief interest of most manufacturers lies in the increasing demand for their products by retailers who are engaged in popularising the system. This does not mean that they can afford entirely to ignore its workings. If the system is unsound, or if a particular retailer employs unsound methods, financial difficulties are bound to arise sooner or later and eventually cause loss to manufacturers through bad debts and reduced sales. Whether there are more serious and immediate dangers is a question which does not appear to have attracted much thought up to the present.

Hire-purchase has been welcomed in many quarters as a remedy for the depression from which certain industries are suffering. That it may be no more than a palliative is rarely hinted, and that there may be a risk of definitely evil effects on trade is regarded as a remote contingency. Nevertheless these possibilities are foreseen by economists, and while it would require considerably more than a chapter to explore the question in detail, it may be helpful to indicate briefly the grounds on which their fears are based.

A manufacturer who finds the demand for his products increasing beyond the capacity of his factory has to extend his plant and raise his output; otherwise his customers become dissatisfied at finding their requirements are not met and his business suffers. Not only must he be able to cope with the existing larger demand, but he must plan ahead so as to be able to meet future demands. In addition, he will probably have to carry heavier stocks so that he can effect prompt delivery of orders. So long as the market for his goods is maintained in accordance with his expectations he will be successful, but if suddenly there is a slump he will find himself left with a factory which he cannot keep fully employed, and, to make matters worse, a large stock of finished goods and raw materials which he cannot afford to carry and cannot readily sell except at a loss.

It must be evident that the growing popularity of hire-purchase has materially stimulated the demand for certain classes of goods and given an abnormal impetus to trade, as a very much larger quantity of goods can be purchased without any addition to customers' cash resources. Even the most optimistic cannot reasonably hope that hire-purchase sales will increase during the next decade to the same extent as during the last. It seems somewhat problematical whether they will even remain at their present level. The conversion of a large section of the public from cash to hire-purchase customers has opened up a new source of demand, and numbers of people have availed themselves of the opportunity to acquire articles which they were previously unable to afford. Having thus satisfied their wants in such directions, the ensuing year or two is occupied in paying the instalments, a process which may be attended by a restriction of their cash purchases. Hire-purchase now embraces a wide range of articles appealing to every section

of the public, initial payments have been reduced and the period of credit extended to a point beyond which it seems unwise to go, and, as a consequence, it is difficult to see what new fields can be exploited so as not only to maintain sales at their present level but to sustain the rate of increase which has operated during the past few years. For reasons just explained, a diminution in the rate of increase, unless counteracted by demands from other directions, is likely to upset the calculations of manufacturers supplying those markets which depend on hire-purchase, and leave them with a surplus production which they will have difficulty in selling. To say that there are always people coming forward to take advantage of the system is beside the point. The crucial fact is that the past few years have seen abnormal demands in certain directions and it is useless to plan production on a scale which assumes the same rate of increase unless there are reasonable grounds for doing so.

It is probably true that hire-purchase has stimulated the trade of a large number of businesses and thereby found employment for persons who might otherwise have been out of work. The purchasing power of the latter has thus been increased and this in turn assists the recovery of trade. Again, there is probably considerable foundation for the claim that manufacturers who benefit by an increased demand for their products as a result of hire-purchase are able to reduce their costs and are thereby in a better position to compete in foreign markets. One has only to look at the motor industry to realise this. Before there is a set-back in hire-purchase, it is possible that the cumulative effect of these and other influences will operate to relieve trade depression, when the slowing down of hire-purchase trading may have no visible effect. In such a case those who pin their faith on the system will be justified, but an endeavour has been made

to show that fulfilment of their hope is not a foregone conclusion.

The problem is one for the economist, and has recently been explored in a book by Mr. W. F. Crick.* The present volume is more immediately concerned with financial aspects of hire-purchase, as for example the treatment of sales in the books of account of a business, ascertainment of the profit on hire-purchase transactions, bad debts, the preparation and presentation of balance sheets for publication and the methods which retailers employ to enable them to grant the extensive credit given to customers. Before these questions can be dealt with, however, it is necessary to review briefly the legal aspect of hire-purchase.

* "The Economics of Instalment Trading and Hire-purchase" by W. F. Crick; Pitmans, 1929.

CHAPTER II

THE LEGAL POSITION

VARIOUS TERMS EMPLOYED :—

HIRE-PURCHASE SYSTEM.

DEFERRED PAYMENT SYSTEM.

“ NO DEPOSIT ” SYSTEM.

THE HIRE-PURCHASE AGREEMENT.

THE DEFERRED PAYMENT AGREEMENT.

STAMP DUTY.

GUARANTEES.

LIEN.

DISTRESS.

BANKRUPTCY.

BILLS OF SALE.

II.—THE LEGAL POSITION

Various Terms Employed

BY reason of the various expressions used to convey the idea of hire-purchase, some confusion exists as to the exact meaning of the term and the legal obligations which a hire-purchase agreement imposes upon the contracting parties.

Hire-purchase System

A contract of hire-purchase can be best explained as an agreement whereby a customer hires goods from a retailer or manufacturer for a specified period on certain terms, and, in so agreeing to hire, acquires an option to purchase the goods at the end of the period for a nominal sum. Alternatively, the agreement may provide that the goods shall become the property of the customer when the payments for hire amount in the aggregate to an agreed sum representing the sale price. Sometimes there is also an option to acquire the goods at any time on payment of the difference between an agreed sum and the amounts paid for hire under the agreement.

Payment for hire over a period, with an option to purchase, is the essence of the Contract. Until the option to purchase is exercised no legal sale takes place; that is, ownership of the goods does not pass to the customer but remains vested in the vendor. Hence the former can terminate the agreement and return the goods at any time on paying up all instalments for hire which have become due. If, however, the customer fails to pay his instalments, the seller can terminate the agreement and, by virtue of his legal ownership of the goods, resume possession of them.

This principle of hire and option to purchase as the essence of the contract distinguishes the hire-purchase system from other methods of selling which may appear at first sight to be the same.

Deferred Payment System

The "Deferred" or "Extended Payment" System is a term which is frequently misused. It is being rapidly adopted as a synonym for hire-purchase, and, as such, is found in every-day use. Strictly speaking, however, it should be reserved to describe a system of selling which, in its legal effect, is quite the opposite of hire-purchase.

Under this system, sale of the article is completed at once, ownership passes from the retailer to his customer on delivery, and payment is deferred. For example, a person may purchase goods to the value of £12, and obtain immediate delivery on paying £1 down and agreeing to discharge the balance by monthly instalments of £1. The question of hire does not enter into the contract, neither is there an option to purchase the goods or one to return them. The retailer has no specific charge on the goods and cannot recover them without first having recourse to the Courts and obtaining an order for payment of the price. He can, however, enforce fulfilment of the contract and payment of all instalments whether the customer returns the goods or not.

Thus it will be seen that the "Deferred" or "Extended Payment" system is not hire-purchase, and having regard to the place which both occupy in the commercial life of the country, the distinction is worthy of more than passing notice.

"No Deposit" System

There are other terms, notably those employed in the

advertisements of business houses, which merely serve to describe some special feature of hire-purchase offers. One of the foremost examples of these is the "No Deposit" system.

For years it was customary for the seller to require a substantial initial payment or deposit from his customer and only the balance of the price was divided into equal instalments. This gave an earnest of the customer's financial position, and obtained for the retailer good security for the amounts unpaid. The practice is still customary in the motor trade and where articles are subject to rapid depreciation, but the general tendency at the present time is to divide the total price into equal instalments, so that the first payment is no greater than the others. Hence arises the expression "No Deposit" system.

In this connection it is interesting to observe that one London retail house now advertises a hire-purchase system whereby goods are delivered to approved customers without any payment whatsoever, and the first instalment falls due one month after delivery.

It will thus be seen that there are two distinct systems in operation in England. The one—hire-purchase—where the customer hires the goods for a fixed period with an option to purchase them at the end of that time for a nominal sum, or to terminate the hiring at any time and return the goods; the other—deferred payment—where a definite sale is effected at once and credit is granted for an extended period.

The Hire-purchase Agreement

The legal position of a retailer and his customer on entering into a hire-purchase agreement is one which depends wholly upon the wording of the agreement itself.

There is no statutory form, but the following is an example in common use :—

No. 12345.

6d.

AN AGREEMENT made the 5th day of *September, 1928* between Blank Furnishers, Ltd., of Grand Street, London, W. (hereinafter called the "Owners," which expression includes their successors and assigns) and

Mr. John Smith, of 999 Black Street, N.

(hereinafter called the "Hirer").

WHEREBY the Owners agree to let and the Hirer agrees to hire the Articles scheduled hereto, and it is hereby agreed between the parties as follows :—

1. The Hirer shall pay to the Owners on or before delivery the sum of £1 os. 0d. for the option to purchase herein given, and £1 os. 0d. on the 5th day of *October 1928*, and of each succeeding month by way of hire so long as the Hirer sees fit to continue the hiring.

2. If the terms and conditions of this agreement be duly fulfilled by the Hirer, the Articles shall become the property of the Hirer when the amounts paid under Clause 1 hereof aggregate £20 os. 0d., but meanwhile the Articles shall remain the sole property of the Owners. The Hirer may at any time during the currency of this agreement purchase the Articles by paying the difference between £20 os. 0d. and the amounts already paid under Clause 1, but in that event the Hirer shall be entitled to a rebate of interest calculated at the rate of 4 per cent. per annum on the difference so paid after deducting any hire in arrear, such rebate being calculated by reference to the due dates of the future hiring payments.

3. The Hirer agrees to keep the Articles in his or her own possession at the above address, from which premises they shall not be removed without the previous consent in writing of the Owners, and punctually to pay all rent, rates and taxes in respect of the premises where the Articles may be. The Hirer shall not nor shall he or she attempt to sell, pledge, charge or otherwise deal or part with the Articles or any of them or with his or her interest in this agreement (which shall not be assignable). The Hirer shall not suffer any execution, distress or other legal process to be levied on the Articles nor on the premises where the Articles are situated, and shall not commit any act of bankruptcy or enter into a composition with his or her creditors.

4. In the event of the death of the Hirer (if a man, widow or spinster) or of the Hirer's husband (if the Hirer is a married woman substantially dependent on her husband) during the currency of this agreement, the Articles will, on satisfactory proof of death being produced to the Owners, become the property of the Hirer's legal representatives or of the Hirer as the case may be. Provided always that the death arises from natural causes or from accident and that all the terms of this agreement (including the punctual payment of all sums due) have been duly fulfilled to the date of death.

5. The Hirer shall be responsible for all loss or damage to the Articles howsoever occasioned, but may deduct from any sums paid to the Owners for hire any premiums paid at the normal rate for insurance of the Articles against fire during the currency of this agreement.

6. If the Hirer has committed no breach of his or her obligations under this agreement other than under Clause 1, the Owners agree that if through illness or

unemployment the Hirer is unable to continue payments under this agreement, the Owners will select for the Hirer Articles to the value of the amount paid after making reasonable allowance for depreciation of the remaining Articles and the cost of transport, and after the remaining Articles have been returned forthwith to the Owners in good condition, the selected Articles shall become the Hirer's property.

7. Subject to Clause 9 hereof the Hirer may at any time on giving seven days' notice in writing terminate the hiring by returning the Articles to the Owners at the Hirer's own risk and expense.

8. In the event of any breach of this agreement by the Hirer, or if any of the payments due under Clause 1 hereof remain unpaid for a period of 14 days, the Owners may by written notice sent to the Hirer's last known address determine and put an end to this Agreement and shall then be at liberty to retake possession of the Articles, and for this purpose they or their agents may enter any premises which the Hirer may enter on which the Articles may be or be supposed to be.

9. If under Clause 7 hereof the Hirer returns the Articles or under Clause 8 the Owners retake possession of them, the Hirer shall remain liable for any hire up to the date of receipt of the Articles by the Owners, together with any sum necessary to make the amounts paid under Clause 1 equal to 30 *per cent.* of the sum specified in Clause 2 if the Articles have been out of the Owners' possession for a period of one year or less, and equal to 50 *per cent.* of the said sum in any other case.

10. No indulgence granted by the Owners to the Hirer shall prejudice their rights under this agreement on any continuing or subsequent breach.

IN WITNESS whereof the said parties have hereunto
set their hands the day and year first above mentioned.

For Blank Furnishers, Ltd.

Witness
Address
Occupation Secretary.

Witness
Address
Occupation Hirer's Signature.

THE SCHEDULE HEREINBEFORE REFERRED TO
One Oak Dining Room Suite £20 0 0

It will be observed that the preamble of the agreement recites that the Owner (that is, the retailer) agrees to let, and the Hirer (that is, the customer) agrees to hire, certain articles.

Clause 2 states that the goods are to remain the property of the Owner until the Hirer has fulfilled certain conditions.

These two statements are not of themselves sufficient to protect the retailer from the effect of Section 25 of the Sale of Goods Act, 1893. In brief, this section provides that where a person having bought, or agreed to buy, certain goods, obtains possession of them with the consent of the seller, and sells, pledges, or otherwise disposes of them to another person, who receives them in good faith and without notice of any lien or other right of the original seller, such person shall give a good title in law to his innocent sub-purchaser or pledgee, even though in fact he had no right to sell or pledge the goods.

Unless there is a definite right given to the Hirer to return the goods (such as is conferred by Clause 7) he

becomes a person who has "agreed to buy" and if he disposes of the goods before the instalments have all been paid, anyone innocently purchasing the goods from him, believing him to be the true owner, would acquire a good title to them as against the unpaid retailer.

Clause 7 gives the customer a definite right to return the goods upon complying with certain conditions. Thus the legal relations of the retailer and his customer are brought within the scope of the decision in *Helby v. Matthews* (1895, A.C. 471), where it was held that the possessor of goods who holds them under a hiring agreement, with an option to purchase or return them, cannot give a good title to an innocent sub-purchaser, since he has neither bought nor agreed to buy the goods.

Clauses 3 and 5 are designed for the protection of the Owner after the goods have left his possession. It is obvious that he should know at all times where they are situated in case the necessity arises to resume possession under Clause 8. He should be assured also that the goods remain free of charges and do not become the subject of legal process.

Clause 5 protects the Owner from loss or damage to his goods by requiring the Hirer to keep them insured. The latter is, however, allowed to deduct the premiums paid by him from his instalments. Some traders prefer to arrange their own insurance, and in such cases it is not unusual to find that only the trader's beneficial interest in the goods is insured. That is to say, it is assumed that as the Hirer pays his instalments, a rateable proportion of the beneficial interest in the goods passes to him from the retailer. Hence the value which the latter has to keep insured diminishes monthly, and the premium is graded accordingly. Arrangements can usually be made to insure the Hirer's interest in the goods on payment by him of a small premium.

Clause 8 is a necessary protection to the Owner enabling him to recover his goods when payment of the hire falls in arrear.

Clause 9 is designed to act as a deterrent to people who may enter into a contract without any intention of completing the purchase of goods, but merely as a means of obtaining use of them for a period as cheaply as possible. By requiring payment of at least 30 per cent. of the instalments if goods are returned within a year, the retailer is compensated for any depreciation resulting from usage. The percentages inserted in the agreement will naturally be varied according to the nature of the goods on hire.

The special concessions granted to the Hirer in certain emergencies are contained in Clauses 4 and 6. In the former the Owner agrees that in the event of the Hirer's death the goods shall become part of his estate. In the latter he agrees that if through sickness, unemployment, or other unforeseen circumstance, the customer is unable to continue his payments, he shall be entitled to retain articles to the value of the instalments paid, whilst the retailer receives back the remainder.

It will be seen from the foregoing that the wording of the agreement requires very careful consideration, especially to ensure that the retailer's interests are adequately protected. The form should not be too restrictive or burdensome upon the hirer, however, and in practice it will be found that the agreements in use by leading houses at the present day are eminently fair.

The Deferred Payment Agreement

It is of interest to compare the hire-purchase agreement and its numerous clauses designed to meet every eventuality with the brief contract used in a Deferred Payment Sale.

Earlier in this chapter it has been stated that a Deferred

Payment Sale contains no element of hire. It resembles a short credit sale except that payment is made by instalments spread over an extended period. There is no option to purchase or return the goods, and therefore the agreement can be drawn up in very simple terms.

A typical example reads :—

To The Furniture Stores, Ltd., London, W.C.

Date 5th September 1928.

Please deliver to me the following goods, viz. :—

One Dining Room Suite	£29
One Bookcase	15
One Bedstead	6

The total price of which amounts to £50

I enclose a remittance for the sum of £10 and agree to pay you the balance by monthly instalments of £4 commencing on the 5th day of October 1928.

(Signed) JOHN CITIZEN.

Address : 998 Black Street, N.

Occupation : Checkweighman.

Here is an order to deliver goods offered for sale by the retailer and when the contract is completed by acceptance of the customer's signed order it becomes binding upon both parties.

This is of importance when considered in conjunction with Section 25 of the Sale of Goods Act, 1893, to which reference has already been made. It will be readily appreciated that the customer by signing the contract becomes a person who has bought or agreed to buy within the meaning of the Act, and as a consequence, after the goods have been delivered to him, a third party acting

in good faith to whom they are transferred, will obtain a good title even though instalments of the price remain unpaid.

Thus there is a wide difference, which may be of far-reaching importance, between a Deferred Payment Sale and one on hire-purchase terms.

Stamp Duty

Deferred payment contracts which are unqualified agreements for the sale of goods are exempt from Stamp Duty. Hire-purchase agreements are by Section 7, Finance Act, 1907, liable to a Stamp Duty of 6d. when given under hand, exemption being granted to agreements the matter whereof is not of the value of £5; agreements under seal are liable to a Stamp Duty of 10s.

Guarantees

In certain cases, as for example, when a customer is a minor, a third party is required to guarantee due fulfilment of the terms of the hire-purchase or deferred payment agreement. The guarantee is not required to be in any particular form, but under Section 4 of the Statute of Frauds it is not enforceable by action unless the guarantor signs a written Memorandum. The following will suffice :—

GUARANTEE

To Blank Furnishers, Ltd.,
London, W.

6d.

In consideration of your supplying Mr. John Smith, of 999 Black Street, N., with the goods specified in the Schedule to the attached agreement, I, Owen Moore, of 997 Black Street, N., hereby guarantee the punctual payment of all instalments due or falling due in respect thereof and fulfilment of all the terms and conditions of the said agreement.

Witness	Signature
Address	Date
Occupation	

When dealing with customers whose accounts have been guaranteed it is important to remember that the surety is released from liability if a binding arrangement is made to give a customer time in which to pay. This is a very old established rule of law, the reason for which is that when a creditor gives time to his debtor, he puts it out of the power of the surety to sue the debtor, and the surety is thereby prejudiced.

In *Midland Motor Showrooms v. Newman* (reported in the *Solicitors' Journal*), T. had agreed to purchase a motor-car under a hire-purchase agreement, and N. had agreed to guarantee performance of the contract. T., having fallen into arrear with his instalments, offered to pay £20 on account and the balance of the arrears at the end of the month. The offer was accepted in writing and a cheque for £20 was paid. It was held that this constituted a binding agreement to give time and operated to discharge the surety from all liability (see 73, *Solicitors' Journal*, at p. 93).

If it is desired to give a customer time in which to pay without releasing the surety, the correct procedure is to reserve all rights against the surety when writing to the customer. He, by accepting the reservation, is deemed to agree that the rights of the surety are not affected and there is thus no reason for holding the latter to be released from his obligations under the guarantee.

Lien

It will sometimes be found that an article supplied on hire-purchase terms has attached to it an owner's plate or mark which is not removed until all instalments are paid. This is quite usual in the case of railway wagons, and may also be seen on motor-cars and gas appliances. It affords protection to the owner against the lien of a

repairer for his charges in respect of goods removed to him for repair. If goods which are the subject of a hire-purchase agreement are given to a third party for repair, and the latter has no notice of the interest of the true owner, he is entitled to a lien on such goods for his unpaid charges, but attachment of an owner's plate may defeat this.

In certain cases, however, dependent upon the wording of the hire-purchase agreement, a repairer might acquire a lien on goods which bear an owner's plate, as for example, when the agreement requires the hirer to keep the goods in repair. It might be held that such a provision constituted the hirer agent of the owner for the purpose of ordering repairs to the goods, in which event the repairer's lien would still apply.

An interesting example of immunity from lien of goods which are the subject of a hire-purchase agreement arises from the position of railway companies providing haulage for private owners' wagons. A colliery may transport coal in its own wagons, the railway company supplying engines to haul them. In such circumstances the company has a lien over wagons on the railway for its charges. If, however, the colliery is buying the wagons on the hire-purchase system, the lien does not operate against the legal owner, as he is not responsible for payment of the charges and the wagons cannot be detained.

Distress

Although goods which are the subject of a hire-purchase agreement cannot legally be seized under an execution, they are liable to be distrained upon by a landlord in common with goods belonging to the hirer absolutely, and no wording of the hiring agreement can avoid this. This situation arises from the Law of Distress Amend-

ment Act, 1908, which exempts from distress goods belonging to any person who is not a tenant of the premises provided he serves on the landlord notice that the goods belong to him. The Act is not to apply, however, to goods comprised in any hire-purchase agreement, which consequently remain liable to seizure.

It will be observed that Clause 3 of the example given on page 26 requires the hirer to pay punctually all rent, rates and taxes, and not to suffer any execution or distress to be levied. Although breach of this condition would entitle the owner to terminate the agreement and recover damages from the hirer, it would not save him from having to pay out the landlord before he could regain possession of the goods.

It should be noticed that if the owner terminates the hire-purchase agreement before distress is levied, the hirer has no longer any right to the goods, and the owner is free to recover them even after the landlord has entered, provided he gives the requisite notice. In *Smart Bros., Ltd. v. Holt and Others* (K.B.D.) (167 L.T.J. 458) D. had acquired goods from the plaintiffs under a hire-purchase agreement whereby he undertook to pay punctually the monthly instalments and also the rent of the premises on which the goods might be. The owners were entitled to terminate the agreement by written notice and thereupon the hirer ceased to have any rights thereunder. Instalments having fallen in arrear the plaintiffs terminated the agreement, and a week later distress for rent was levied and the goods were seized. It was held that when notice was given terminating the agreement, the right of the hirer to possession of the goods was at an end. The plaintiffs had an ordinary common law right to recover the goods independently of the agreement, and the goods were consequently not "goods comprised in any hire-purchase agreement"

when distress was levied. As the plaintiffs had served on the landlord notice of their interest in the goods, their action for illegal distress therefore succeeded.

Bankruptcy

In the event of bankruptcy of the hirer, the rights of his trustee will depend upon whether or not he is engaged in business. In certain circumstances, the doctrine of reputed ownership applies to the bankruptcy of a trader and enables his trustee to claim goods which are in his possession by virtue of a hire-purchase agreement.

If the hirer is not engaged in business, the goods do not pass to the trustee, as he acquires no greater rights than were possessed by the bankrupt himself.

A Bill has been promoted in Parliament with the object of altering the law so that goods which are the subject of hire-purchase agreements shall in all cases be protected from seizure under legal process, but efforts to secure the passage of the measure have so far been unsuccessful.

Bills of Sale

The need for drafting the hire-purchase agreement in the form indicated has arisen because there is in England no simple method of mortgaging personal chattels. This is quite opposed to the practice in America, where instalment sales usually consist of immediate sales to customers who then execute chattel mortgages in favour of the retailers as security for the unpaid instalments.

The only parallel to the American chattel mortgage to be found in English jurisprudence is a Bill of Sale.

Absolute Bills of Sale, as governed by the Bills of Sale Act, 1878, give no right of redemption to the grantor and are therefore unsuitable for securing repayment of

money. They are too cumbersome for every-day use, since they require registration and have to be explained to the grantor by a solicitor.

Conditional Bills of Sale are governed by the Act of 1882, and give the grantor a right of redemption, but they must be for a consideration of not less than £30, must be in the exact form required by the Act, and require registration.

Thus Bills of Sale are unsuited to the requirements of modern business conditions under which numerous sales of varying amounts take place daily, and this has materially assisted the development and perfection of the hire-purchase agreement.

CHAPTER III

BOOKKEEPING SYSTEM

INTRODUCTORY REMARKS.

COMPLETION OF THE SALE AND HIRING AGREEMENT.

DISSECTION OFFICE.

RUNNING SUMMARY OF INSTALMENTS FALLING DUE.

BOOKKEEPING DEPARTMENT.

RECEIVING CASHIER'S DEPARTMENT.

REPOSSESSION OF GOODS.

PRIVATE LEDGER AND JOURNAL.

THE BALANCE SHEET.

III.—BOOKKEEPING SYSTEM

Introductory Remarks

IN view of the legal distinction which has been drawn between a contract of hire-purchase and a contract of sale it would seem that, in the books of account of a business, hire-purchase transactions should not be recorded as sales but as dealings between an owner of goods and his customers hiring them. In other words, the hirers' accounts in the owner's ledger should reflect the position of debtor and creditor only for hiring charges as and when they fall due under the agreements; no debit to a customer's account for the full amount of the contract should appear.

This method would be found in practice both cumbersome and inexpedient. It is, of course, necessary to have regard to the legal position when preparing the form of hire-purchase contract; but at the same time it should be borne in mind that hire-purchase trading is generally regarded by business men as a means to an end—a method of increasing turnover and attracting new customers. Consequently in books of account the treatment of transactions is, in the first instance, very similar to that of ordinary credit sales, the full amount of the instalments payable by a customer being entered at the head of his ledger account, and cash paid by him being credited.

So long as the true position of affairs at a given date can be readily ascertained from the books, the principles upon which they are kept appear to be chiefly the concern of the trader, and it is submitted that where proper agreements exist, little harm results in practice if the book-keeping system does not strictly reflect the legal position.

It has been suggested that if it became necessary to institute legal proceedings against a customer and his ledger account had to be produced, complications might ensue if the account revealed that the transaction had been treated as a sale, but the mere fact of entering the full amount of the instalments on his account should not be allowed to override the effect of the hire-purchase agreement signed by the customer.

Further consideration will be given to the theoretical treatment of hire-purchase dealings, including the principles underlying the various methods of ascertaining the profits earned and the different ways of disclosing the results of the transactions in published accounts.

Meanwhile in this chapter there is described a practical method of keeping the books of account—a system which may be applied both to hire-purchase and deferred payment sales. As emphasis has already been laid on the legal position, both classes of transactions may for convenience be referred to as “sales” and the instalments which customers agree to pay as “debts.”

In order to give scope to the illustration it will be assumed that the retailer is a large departmental store conducting an extensive hire-purchase business involving several thousand accounts with customers. If the work of the Accounts Department is to be conducted efficiently it will be necessary to provide a system of sectional or self-balancing personal ledgers whereby the discovery of clerical errors and extraction of the trial balance can be facilitated.

Goods are marked at hire-purchase prices and discount from such prices is allowed to customers who buy for cash.

The sale of a suite of furniture on hire-purchase terms will be taken as representative of the numerous transactions which occur daily. An agreement with Mr. John Smith has already been given on page 26, and this

sale will be traced through the usual stages from its origin at the counter until it is recorded in the books of account, and the preparation of a balance sheet and trading and profit and loss accounts from the books will be explained.

Completion of the Sale and Hiring Agreement

The salesman commences the records by writing out the equivalent of a sale note for the goods. This note is of the form in common use for sales at the counters of most retail stores. It is usually provided in duplicate and for hire-purchase transactions it is advisable to have notes of a distinctive colour from those used for cash and credit sales. An easy means of identification such as this is an invaluable aid to speedy and accurate work in the accounting departments through which the note will pass.

The first copy of the sale note is passed to the dissection office—a department whose functions will be considered later—and the second copy is handed to the hire-purchase manager on the introduction of the customer to him by the salesman.

Many houses provide a third copy of the sale note for the use of the salesman in compiling the weekly total of sales upon which his commission is based. This saves entering up a summary at the time the sale note is prepared.

The customer is next asked by the manager of the hire-purchase department to sign a proposal form, an example of which is given on page 44. (Example 1.) When completed, this form should give the manager sufficient information to enable him to judge whether his customer is a responsible person able to fulfil the obligations into which he proposes to enter.

Although some houses dispense with them, references

PROPOSAL FORM

Name in full

Permanent Private Address

State if Householder

How long a Householder ?

State if age over 21

Occupation

Business Address

Address to which goods are to be
delivered

References :

1. Name

Address

2. Name

Address

EXAMPLE 1

are often required and upon these being taken up and found satisfactory, the agreement is prepared in duplicate from the sale note and proposal form. One copy signed by the hire-purchase manager on behalf of the store is handed to the customer, and the other, signed by the customer, is filed by the manager together with the sale note and proposal form.

The first payment having been made by the customer, an advice is despatched from the hire-purchase manager's office to the salesman and he in turn makes arrangements for delivery of the suite.

To facilitate reference, some hire-purchase managers keep an alphabetical register of all agreements in the form shown on the opposite page. (Example 2.)

At the time of preparing the agreement a carbon copy should be taken of the particulars entered in the first two

HIRE-PURCHASE AGREEMENTS

Date	Name	Address	No. of Agreement	Amount	Initial Payment	Instalments		How payable
						No.	Amount	
19 ²⁸ Sept. 5	Smith, J.	999 Black Street, N.	12345	\$ 20 0 0	\$ 1 0 0	19	\$ 1 0 0	Monthly

EXAMPLE 2

clauses. (Example 3.) This will serve as an advice to the bookkeeping department and form the posting slip from which will be entered the debit to the customer's account.

ADVICE OF HIRE-PURCHASE AGREEMENT TO BOOKKEEPING DEPARTMENT	
No. 12345	Date 5th September, 1928
Name : Mr. John Smith	Address : 999 Black Street, N.
Amount of first payment .. £1 0 0	
Amount of each instalment .. £1 0 0	5th October, 1928
Aggregate Sale Price .. £20 0 0	Number of Payments 20

EXAMPLE 3

At frequent intervals the advices are forwarded in numerical order to the dissection office where, before being dealt with in the bookkeeping department, they are treated in the manner described below.

Dissection Office

This department is independent of the bookkeeping department and functions chiefly in summarising the many detailed transactions which go to make up the business of the store. Such summaries, besides being used for statistical purposes, operate as checks upon the entries in the financial books.

The serial numbers of all sales notes are scrutinised by clerks in the dissection office to ensure that none is mislaid or destroyed either inadvertently or otherwise. The hire-purchase sale notes are then listed on adding machines and a daily total is obtained of all hire-purchase transactions effected in the selling departments of the store. It is one of the duties of the chief clerk in the dissection office to ascertain that all sales are duly accounted for by the eventual preparation of agreements with customers. To this end the hire-purchase manager furnishes him with daily totals of the duplicate copies of the sale notes coming into his hands which should agree with the totals obtained in the dissection office. Should a sale be cancelled and no agreement be prepared, a credit note must be made out by the salesman.

It will shortly be seen that the dissection office also obtains a total of the sales for which agreements have been completed. In order to agree this figure with the sale notes, the hire-purchase manager furnishes, at the end of each month, a total of those sale notes for which agreements have not been completed. To prove the accuracy of the figures for the month, the following short summary is then prepared in the dissection office :—

	£	s	d
Sale notes outstanding last month ..	56	0	0
Sale notes entered this month, <i>less</i> credit notes	8,650	0	0
	<u>8,706</u>	0	0

Less :—

Sale notes outstanding this month ..	<u>94</u>	0	0
Balance, being agreements completed this month	<u>£8,612</u>	0	0

The sale notes are next analysed according to the salesmen who have made the sales and thus particulars are obtained which, after having been agreed with the salesmen's summaries, form the basis of their selling commission.

Date		Total	Ledgers			
			A—F	G—O	P—S	T—Z
1928						
September	1	£ 310 0 0	£ 128 6 0	£ 60 4 0	£ 78 10 0	£ 43 0 0
	3	280 0 0	86 10 0	103 5 0	42 0 0	48 5 0
	4	320 0 0	200 0 0	41 0 0	30 0 0	49 0 0
	5	300 0 0	65 4 6	112 5 6	20 0 0	102 10 0
	6					
	7					
&c.						
Monthly Total	..	£8,612 0 0	2,176 8 0	1,994 3 0	2,543 6 0	1,898 3 0

EXAMPLE 4

Turning now to the carbon copies of the agreements which are to form the posting slips for the ledgers, they have to be totalled daily and analysed according to the alphabetical sections of the Customers Ledger. A book summarising the results of the analysis is kept by the chief clerk in the dissection office and the amounts shown therein ultimately serve as a valuable check on the accuracy of the debits posted to customers' ledger accounts (Example 4 on opposite page).

The amounts in the total column represent the hire-purchase sales for which agreements have been completed. Reconciliation of these amounts with the sale notes has already been explained.

To enable the reader to trace the £20 transaction with Mr. Smith through the various books, this amount is shown in the example as the only debit to the P—S Ledger on the 5th September.

Running Summary of Instalments Falling Due

The dissection office also furnishes a monthly analysis of the hire-purchase accounts arranged according to the number of monthly payments required to complete the contracts. The analysis may be as follows:—

Month of September 1928											
Period of Agreements			Aggregate Sale Price			Initial Payments			Monthly Instalments		
			£	s	d	£	s	d	£	s	d
6 months	..	..	1,566	0	0	311	0	0	251	0	0
9	..	..	954	0	0	106	0	0	106	0	0
12	..	..	2,448	0	0	248	0	0	200	0	0
20	..	..	20	0	0	1	0	0	1	0	0
24	..	..	3,624	0	0	151	0	0	151	0	0
Sales for the month	..		£8,612	0	0						

From this analysis there is compiled a Running Summary of the instalments falling due in future months which may be kept in a book ruled as shown in Example 5 on page 50.

RUNNING SUMMARY OF HIRE-PURCHASE INSTALMENTS FALLING DUE

Date	Period of Ag'm'ts	Am't of Sales	1928				1929				1930			
			Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	&c.	Jan.	Feb.	&c.
1928 Sep. 30	Forw'd	£ 65,228	£ 3,700	£ 3,610	£ 3,421	£ 3,296	£ 3,147	£ 2,943	£ 2,860	£ 2,635		£ 1,291	£ 1,212	
	6 mths	1,566	311	251	251	251	251	251	106	106				
	9 "	954	106	106	106	106	106	106	106	106				
	12 "	2,448	248	200	200	200	200	200	200	200				
	20 "	20	1	1	1	1	1	1	1	1		1	151	
	24 "	3,624	151	151	151	151	151	151	151	151		151	151	
	<i>Alcs prep'd G. L. A. B.</i>		96	12	12	12	12	12	12	12		8	8	
	<i>Deduct Sept.</i>	73,860	£4,757											
	<i>Bal'ce</i>	4,757												
Oct. 31	&c.													
Nov. 30	&c.													
Dec. 31	6 mths	1,764				294	294	294	294	294				
	12 "	1,800				150	150	150	150	150				
	24 "	1,200				50	50	50	50	50		50	50	
	36 "	4,452				129	123	123	123	123		123	123	
	<i>BadDebts Smith E. G. T. W.</i>					16	1	1	1	1		1	1	
						18	2	2	2	2				
	<i>Deduct Dec.</i>	84,639				6	1	1	1	1				
		5,249												
	Forw'd	£79,390				£5,249	£5,090	£4,834	£4,760	£4,629		£3,092	£2,964	

The requisite number of columns to contain a running summary of instalments which may be spread over long periods such as three years or more can best be obtained by the employment of a loose-leaf book into which "short" leaves can be inserted.

It will be seen from the example that by carrying forward from page to page the total of each monthly column the amount of instalments falling due in any month can be readily ascertained. As each month is completed the appropriate column is ruled off and the total of the instalments falling due in that month is deducted from the accumulated total of the instalments, leaving the remaining columns in agreement with the balance of the total column.

Adjustments will be necessary when a customer terminates his agreement by paying up the outstanding instalments before they fall due and when a debt is written off as bad. In the first case the adjustment is effected by crediting the appropriate future months with the prepaid instalments and debiting the month in which they are paid. In the second case the instalments (in so far as they have not fallen due) will be credited to the appropriate months in which they would have become due and debited to the month in which they are written off.

Such a running summary as has been described provides the basis of an account in the Private Ledger, entitled "Sundry Debtors for Instalments Due," which will be found to afford a valuable indication of the rate at which instalments are being received. Financial Estimates and Budgets are rapidly assuming an important place in scientific business management and in the compilation of these the value of accurate accounts of instalments receivable month by month will be appreciated.

Bookkeeping Department

After the posting slips have been analysed in the dissection office as described, they are passed daily to the ledger clerks in the bookkeeping department, who first total them to ensure that none is missing. The totals having been agreed with the dissection office amounts, the clerks proceed to open an account for each agreement and debit the customers with the gross amounts of the sales. When a customer has two or more agreements in force, a separate ledger account should be opened for each, reference being made to the fact on each account as well as in the ledger index.

No sales day book need be kept, the daily total of slips posted to the debit of each ledger being entered in a summary book. One of these is kept for each ledger and may take the form shown on the opposite page. (Example 6.)

The total of the column headed "Debits for Month" should agree with the corresponding column of the hire-purchase sales control book in the dissection office. The purpose of the remaining columns is apparent from their headings, and after being agreed with the relative controlling books the entries should be made daily. The balance must, of course, agree with the detailed list of balances extracted from the ledgers and need only be extended into the last column monthly.

Posting ledgers from carbon copies of original records, as described, is known as the Slip System of posting. By this system and the use of suitable office machinery, particularly listing and adding machines, considerable saving in clerical labour may be effected. A sales day book is dispensed with, all unnecessary hand copying is avoided, and risk of error in the work of the ledger clerks is reduced to a minimum. After the slips have been

Dr.		P—S LEDGER SUMMARY BOOK							Cr.	
Date		Balance brought forward	Debits for Month	Transfers	Cash Refunds	Cash Received	Transfers	Discounts and Allowances	Balance carried forward	
1928.	I	£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	
Sept.	3	9,324 10 8	78 10 0			20 4 6				
	4		42 0 0			51 10 0				
	5		30 0 0			20 4 0				
&c.			20 0 0			71 10 6				

EXAMPLE 6

posted they may be sorted into any required order or groups to facilitate the preparation of statistics. It will be apparent that, in hire-purchase trading, statistics are of great value to the management in following the trend of the business and formulating their policy. For this reason the system will be found a valuable asset in the counting house as it enables any required analysis of the sales to be readily prepared, as for instance according to geographical distribution or classes of goods sold.

In some offices the slip system is not favoured owing to partiality for a sales day book and risk of errors being made by an untrained staff. When a sales day book is desired—as in the case of some small offices—it is found advantageous to record hire-purchase sales in a loose-leaf book. Separate sheets are used for agreements which extend over different periods of payment, and columns are provided for “Total Debit,” “Initial Payment” and “Instalments” to correspond with the analysis of sales prepared in the dissection office and shown on page 49 (cf. Example 16). The sheets can then be totalled monthly and furnish a ready means of obtaining the figures for the Running Summary of Instalments falling due.

While this method may give satisfaction in a small office, it has not the advantages of the slip system which is rapidly coming into favour as modern practices are better understood. The slip system does not depend for its success on the existence as a separate department of a dissection office or its equivalent; it can be easily incorporated into the ordinary office routine, and, provided that elementary precautions are taken against error, should give entire satisfaction.

The form of ledger account is largely a matter of individual choice, but, of those in use, one which has been found satisfactory is shown opposite. (Example 7.)

HIRE-PURCHASE SALES LEDGER ACCOUNT CARD

Name: *John Smith* Address: *999 Black Street, N.* Account No.
 Date of Agreement: *5th September 1928.*
 No. of Agreement: *12345.* Amount of first payment: *£1 0 0*
 Total Amount payable: *£20 0 0* 19 Instalments of: *£1 0 0*

Date	When due	Refce.	Cr.	Balance	Date	When due	Refce.	Cr.	Balance
1928			£ s d	£ s d				£ s d	£ s d
Sept.	6		1 0 0	19 0 0					
Oct.	10		1 0 0	18 0 0					
Nov.	30		1 0 0	17 0 0					
Dec.	15		10 0 0	7 0 0					
			7 0 0	— — —					

EXAMPLE 7

It will be seen that the necessity for periodically ruling off accounts and carrying down balances is avoided. Where adjustments have to be made on an account which call for further debit entries, they may be effected by the use of red ink as contrasted to black for credit entries.

The selection of a suitable ledger binding or case to contain the accounts deserves careful consideration. Normally an entry has to be made on each account every month and in addition frequent reference to the accounts is needed to discover and follow up overdue instalments. It is therefore important that the type of ledger selected should permit easy reference to the accounts, have a good index, and be easily portable.

There is much to be said in favour of card ledgers. They are obtainable in a variety of forms, but those where the ledger account cards are retained in small hinged trays are perhaps most suitable. The cards overlap each other and lie flat, but the lower margin of each card is exposed to view so that the customer's name can be read. Entries can be made on the cards by hand without removing them from the trays and the latter can be readily removed from the main fixture when required for reference in other parts of the office. The accounts and the trays containing them can be kept alphabetically, thus dispensing with the need for a separate index.

Some forms of card ledgers are particularly suited to machine posting; completed accounts may be easily removed; overdue accounts may be placed in a separate fixture; and the durability of the cards far exceeds that of the usual ledger sheets. Durability is an important consideration when dealing with hire-purchase accounts.

Receiving Cashier's Department

The cashier entrusted with the receipt of instalments is

RECEIPT BOOK

<p>Date _____ A 672486</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>	<p>Date <u>6 Sept. Dec 1928</u> A 672481</p> <p>Received from _____</p> <p>Mrs <u>John Smith</u></p> <p><u>999 Black Street</u></p> <p>N.</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ 1 : 0 : 0</p> <p><u>James Andrews</u></p> <p><input type="checkbox"/></p>
<p>Date _____ A 672487</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>	<p>Date _____ A 672482</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>
<p>Date _____ A 672488</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>	<p>Date _____ A 672483</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>
<p>Date _____ A 672489</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>	<p>Date _____ A 672484</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>
<p>Date _____ A 672490</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>	<p>Date _____ A 672485</p> <p>Received from _____</p> <p>M _____</p> <p>ACCOUNT No. _____</p> <p>For BLANK FURNISHERS LTD. £ : :</p> <p><input type="checkbox"/></p>

provided with a book containing triplicate receipt forms in sheets of 20 or more.

The first copies are handed to the customers who are supplied with stiff cardboard covers in which they may preserve their receipts.

The second copies are removed from the book at the close of each day's business, sorted into ledger order and passed to the ledger clerks so that they may post ~~the~~ amounts to the credit of the customers' accounts in the hire-purchase ledgers. With the aid of adding machines the ledger clerks obtain totals of receipts coming into their hands and enter the amounts daily in the column provided in the respective ledger summary books. (Example 6.)

The third copies remain bound in the book and form the hire-purchase cash book. It is important to arrange the lay-out of the receipts so that the amounts may be readily totalled and balanced with the cash received during the day; the arrangement is shown on page 57 in Example 8. The daily totals are in due course entered in the general cash book and should also be agreed daily with the amounts entered by the ledger clerks in their summary books.

This method of dealing with the receipt of instalments is a further example of the application of the slip system.

When ordinary bound cash books are preferred, customers are usually provided with instalment cards in the form shown. (Example 9 on page 59.)

The cashier enters the receipt of instalments on the cards and immediately records the amounts in a hire-purchase cash book ruled with analysis columns corresponding to the hire-purchase ledger sections. (Example 10 on page 60.) Two books for use on alternate days are advantageous as they facilitate posting the ledgers.

HIRE-PURCHASE CASH BOOK

Date	Name	Address	Pos- ted	A/c No.	Total	A—F	G—O	P—S	T—Z
1928 Sept. 1					£ s d	£ s d	£ s d	£ s d	£ s d
Daily Total to General Cash Book		..			£200 18 10	49 6 3	71 4 9	20 4 6	60 3 4

EXAMPLE 10

Allowances by way of discount to customers who pay up their instalments before they fall due may be entered in a journal, preferably kept in the hire-purchase manager's office, ruled with analysis columns for each ledger section. (Example 12 on opposite page.)

As a check on the cashier it is important that the book should be under the personal supervision of the hire-purchase manager and be initialled by him daily as correct. Attention has already been directed to the adjustments which are necessary in the Running Summary of Instalments falling due when instalments are prepaid.

When a transfer journal is used to record transfers between ledgers, the ruling is similar to that of the discounts and allowances journal.

Repossession of Goods

To illustrate our subject further, it will be assumed that the contract for the hire-purchase of a suite of furniture which we have so far traced through the books is terminated by the trader because the customer finds himself unable to continue his payments. Only three instalments of £1 have been paid and the goods are repossessed by the retailer under the powers conferred upon him by Clause 8 of the agreement. Under the terms of the agreement, therefore, the customer is liable for a further £3 in order to make his payments equal to 30 per cent. of the price of the goods. It is found useless to press for this amount and the only alternative is to write off as a bad debt the balance of the account after making allowance for the value of the goods recovered.

Instead of auctioning the goods they are returned to stock, and the departmental manager agrees to make an allowance of £10. This is customary because, after retouching, furniture can usually be put on sale again, perhaps at a reduced price.

HIRE-PURCHASE DISCOUNTS AND ALLOWANCES JOURNAL

Date	Name	Address	Fo.	A—F	G—O	P—S	T—Z	Total
1928 Sept.	G.L.	..	..	£ s d	£ s d	£ s d	£ s d	£ s d
	A.B.	..	..	7 4 0	4 16 0			
		Monthly Total ..		£7 4 0	4 16 0			12 0 0

EXAMPLE 12

The bad debts journal may take the form shown on the opposite page in Example 13.

Allowances on goods recovered are only entered in the journal when the goods are returned to stock ; when they are sold by auction the proceeds are credited to customers' accounts through the cash book ; the purpose of the remaining columns is evident from their headings.

Amounts in the last two columns are credited in detail to customers' ledger accounts, and the debits to goods account and bad debts account are made monthly through the private journal as will shortly appear. Adjustment for the instalments not yet due, viz. £40, must be made on the Running Summary of Instalments falling due and the amounts written off must be correctly allocated to the appropriate months in the summary.

Private Ledger and Journal

From the various books which have been described, monthly totals are obtained under various headings, and from these the private journal is written up. The entries are as follows :—

From the Dissection Office Sales Control Book (Example 4).
1928.

30th Sept.—Sundry Debtors for Instalments under	
H.P. Agreements	<i>Dr.</i>
To Hire-purchase Sales	£8,612

From the Running Summary of Instalments falling due (Example 5).

1928.

30th Sept.—Sundry Debtors for Instalments due <i>Dr.</i>	
To Sundry Debtors for Instalments	
under H.P. Agreements	£4,757

From the Discounts and Allowances Journal (Example 12).

1928.

30th Sept.—Discounts allowed to H.P. Debtors <i>Dr.</i>	
To Sundry Debtors for Instalments due	£12

BAD DEBTS JOURNAL

Date	Name	Address	Fo.	Amount of Sale	Amount paid	Instal- ments ac- rued due	Instal- ments not yet due	Allowance on goods recovered	Balance to Bad Debts A/c
1928 Dec. 15 18 29	Smith, J. .. E.G... .. T.W. ..	999 Black St.N Finchley .. Ilford ..		£ s d 20 0 0 40 0 0 15 0 0	£ s d 3 0 0 16 0 0 5 0 0	£ s d 1 0 0 6 0 0 4 0 0	£ s d 16 0 0 18 0 0 0 0 0	£ s d 10 0 0 15 0 0 10 0 0	£ s d 7 0 0 9 0 0 — — —
		Monthly Total		£75 0 0	24 0 0	11 0 0	40 0 0	35 0 0	16 0 0

EXAMPLE 13

From the Bad Debts Journal (Example 13).

1928.					
31st Dec.—Purchases	..	..	Dr.	£35	
Bad Debts	..	..	Dr.	16	
To Sundry Debtors for Instalments due	..	..	..	..	£51

The general cash book is balanced monthly and the total of the column headed "Hire-purchase Ledger" is posted to the credit of "Sundry Debtors for Instalments due Account."

Similar entries will be made each month, and in the private ledger the various accounts recording hire-purchase transactions will appear as follows:—

Dr.		HIRE-PURCHASE SALES				Cr.	
1928		Fo.		1928		Fo.	
Dec. 31	To Trading A/c		£ 48,344	July 31	By Sales		£ 7,634
				Aug. 31	"		7,429
				Sep. 30	"		8,612
				Oct. 31	"		8,124
				Nov. 30	"		7,329
				Dec. 31	"		9,216
			<u>£48,344</u>				<u>£48,344</u>

Dr.		SUNDRY DEBTORS FOR INSTALMENTS UNDER HIRE-PURCHASE AGREEMENTS				Cr.	
1928		Fo.		1928		Fo.	
July 1	To Balance		£ 59,314	July 31	By Instalments due		£ 4,500
" 31	" H.P. Sales		7,634	Aug. 31	"		4,629
Aug. 31	"		7,429	Sep. 30	"		4,757
Sept. 30	"		8,612	Oct. 31	"		4,712
Oct. 31	"		8,124	Nov. 30	"		4,421
Nov. 30	"		7,329	Dec. 31	"		5,249
Dec. 31	"		9,216	Dec. 31	" Bal'ce		79,390
			<u>£107,658</u>				<u>£107,658</u>

The balance of £79,390 on this account represents instalments falling due on dates after 31st December, and agrees with the balance carried on the Running Summary of Instalments falling due.

<i>Dr.</i> SUNDRY DEBTORS FOR INSTALMENTS DUE				<i>Cr.</i>			
1928		Fo.		1928		Fo.	
July 1	To Balance		£ 2,467	July 31	By Cash		£ 4,412
" 31	" Instalments due		4,500	" 31	" Disc't		15
Aug. 31	"		4,629	Aug. 31	" Cash		4,579
Sept. 30	"		4,757	" 31	" Disc't		8
Oct. 31	"		4,712	Sept. 30	" Cash		4,834
Nov. 30	"		4,421	" 30	" Disc't		12
Dec. 31	"		5,249	Oct. 31	" Cash		4,692
				" 31	" Disc't		24
				Nov. 30	" Cash		4,519
				" 30	" Disc't		10
				Dec. 31	" Cash		4,586
				" 31	" Disc't		14
				" 31	" Bad Debts		51
				" 31	" Bal'ce		2,979
			<u>£30,735</u>				<u>£30,735</u>

The balance of £2,979 on this account represents instalments which have fallen due prior to 31st December and remain unpaid at that date.

The sum of the balances outstanding on the two latter accounts should agree with the sum of the balances carried forward at the end of the year in the hire-purchase sales ledger summary books. The latter in turn should agree with the total of the customers' ledger balances extracted from the relative hire-purchase sales ledgers.

The Balance Sheet

At the commencement of this chapter it was remarked that, as a matter of commercial expediency, hire-purchase

sales are dealt with in the manner which lends itself most readily to simplification of the bookkeeping records, and the system described in the foregoing pages has in view the achievement of this end. Each sale is debited in one sum to the customer's account, and, in normal cases, subsequent entries only concern the receipt of instalments. It will be seen, therefore, that the treatment of hire-purchase sales, as so far described, does not differ to any great extent from that which would be applied to ordinary credit sales.

Before a balance sheet can be prepared, however, the accounts in the private ledger need adjustment in certain respects, the purport of which will be better appreciated if there is kept in mind the peculiar nature of hire-purchase transactions.

It has already been shown that the debit balance of £79,390 (page 66) represents the gross amount of instalments under hire-purchase agreements which will fall due for payment at various dates after 31st December 1928.

Before this sum can be inserted as an asset in the balance sheet, a deduction must be made for any instalments the receipt of which is known to be doubtful. The deduction is not necessarily the full amount of such instalments and the method of ascertaining the reserve will be fully considered in a subsequent chapter. For the purpose of the *pro forma* accounts given on page 76 an amount of £2,741 has been assumed to be required.

In addition to a specific reserve for debts which are known to be doubtful, a further general reserve should be created to cover debts which, although they appear sound when the balance sheet is prepared, may afterwards prove to be the reverse. The general reserve is usually calculated as a percentage on the debts outstanding, and will vary according to the circumstances of each case and the experience of past years. For the purpose of the

pro forma accounts given on page 76, 5 per cent. has been assumed.

A further reserve, the necessity for which may not at first be quite apparent, has also to be made.

As the instalments are payable over a period which in some cases may extend to nearly three years after the 31st December 1928, they must not be entered in the balance sheet at a sum in excess of their present value at that date. In other words, an allowance must be made for interest on the capital locked up in the debts. It may be calculated at a commercial rate, say 6 per cent., but where the discount allowed to customers on premature settlement of accounts exceeds this rate, the latter should be adopted. When the accumulation of hire-purchase debts has necessitated raising loans to replenish the working capital, and these bear interest at a rate exceeding 6 per cent., the higher rate should be employed when discounting the value of the instalments.

It should be observed that the rate of interest which is assumed in fixing hire-purchase prices has no bearing on the question now under consideration. When the rate is low, it is probably no more than a nominal charge, while a high rate covers not only interest on the instalments but also bad debt risks and expenses of collection. The rate at which instalments are to be discounted for the purpose of the balance sheet should therefore be determined in accordance with the rules laid down above, but the inclusion of a high rate of interest in hire-purchase prices might be an indication as to the basis of the general reserves for bad debts and costs of collection.

In order to calculate the reserve required to reduce the instalments to their present value at the date of the balance sheet, reference is made to the Running Summary of Instalments falling due, and their average due date is ascertained. It would be quite impracticable to calculate

each instalment separately and it is therefore assumed that the instalments payable in any month fall due in regular amounts each day during the month ; or expressed in another way, the instalments falling due each month are payable, on the average, half way through the month.

The method of calculating the average due date of a series of instalments payable over a long period may be illustrated by the following example, in which it is assumed that the instalments are payable over 12 months :—

				Instalments falling due	Factors	Products
				£		£
January	..	..	..	4,000	$\frac{1}{2}$	2,000
February	..	..	..	4,200	$1\frac{1}{2}$	6,300
March	..	..	..	4,600	$2\frac{1}{2}$	11,500
April	..	..	..	4,400	$3\frac{1}{2}$	15,400
May	..	..	..	4,100	$4\frac{1}{2}$	18,450
June	..	..	..	4,800	$5\frac{1}{2}$	26,400
July	..	..	..	4,000	$6\frac{1}{2}$	26,000
August	..	..	..	4,100	$7\frac{1}{2}$	30,750
September	..	..	..	4,600	$8\frac{1}{2}$	39,100
October	..	..	..	4,700	$9\frac{1}{2}$	44,650
November	..	..	..	4,400	$10\frac{1}{2}$	46,200
December	..	..	..	4,500	$11\frac{1}{2}$	51,750
				<u>£52,400</u>		<u>£318,500</u>
				318,500		
				<u> </u>	= 6.078	
				52,400		

The factors in the second column represent the number of months between 1st January and the average due date of each month's instalments, which, as explained above, is assumed to be half way through the month. The total of the products in the third column is divided by the total of the instalments in the first column, giving a figure of 6.078. Hence, the average due date of all the instalments is 6.078 months after 1st January, or, say, 2nd

July. This method may be used whether there are more or less than 12 months' instalments outstanding, and applying it to the figures in the Running Summary of Instalments, it might be found that their average due date was $12\frac{1}{2}$ months after 31st December 1928. The reserve necessary to reduce the instalments to their present value is therefore calculated as 6 per cent. on £76,649 for $12\frac{1}{2}$ months, or £4,790 (see page 75).

Provision must also be made for the cost of collecting the outstanding instalments, since this is an item of expense which contributes to fix selling prices and the accounts cannot be said to show the true profits unless it is charged. The question is reverted to again in the next chapter, and for the purpose of the *pro forma* balance sheet on page 76 a sum of £2,000 has been assumed to be necessary.

A fourth important adjustment arises in respect of the profit on sales which have been recorded in the books during the half-year. To credit the profit and loss account immediately with the whole profit on the sale of goods which are to be paid for over an extended period is considered by some authorities to be undesirable, although opinions differ, and the question will be considered at greater length in Chapter IV.

For the present, it will be assumed that the reserve has to be made, and it remains to explain how it should be calculated.

The position will be better appreciated by preparing a periodical summary of the monthly Running Summary of Instalments, in order to show the total instalments falling due each half-year.

Assuming that the business was commenced on 1st January 1927, this summary might appear as in Example 14.

HALF-YEARLY SUMMARY OF INSTALMENTS FALLING DUE

Date	Amount of Sales	1927		1928		1929		1930		1931	
		30 Jne.	31 Dec.	30 Jne	31 Dec.	30 Jne.	31 Dec.	30 Jne.	31 Dec.	30 Jne.	31 Dec.
30th June 1927 ..	£ 30,000	£ 5,500	£ 8,709	£ 6,976	£ 4,031	£ 3,409	£ 826	£ 549	£	£	£
Less	5,500										
31st December 1927	24,500										
	38,000										
Less	62,500										
	15,000										
30th June 1928..	47,500										
	37,814			8,219	7,621	7,322	6,231	3,321	2,721	2,379	
Less	85,314										
	20,000			26,000							
31st December 1928	59,314										
	48,344				10,542	9,218	7,328	5,924	5,781	4,935	4,616
Less	107,658										
	28,268				28,268						
	79,390										
						25,470	19,494	12,996	9,500	7,314	4,616

EXAMPLE 14

The percentage of net profit on the hire-purchase sales each half-year, before making the adjustment which is now being considered, must be ascertained, and the following rates may be assumed :—

				Per cent.
Half-year ended 30th June 1927	..	..	..	7
„ 31st December 1927	..	..	..	8
„ 30th June 1928	..	..	..	9
„ 31st December 1928	..	..	..	10

If it is desired to credit the profit and loss account each half-year with the profit earned on instalments falling due in the half-year, it will be apparent that the six months ended 30th June 1927 have to receive credit for :—

7 per cent. on £5,500 £385

The six months ended 31st December 1927 have to receive credit for :—

7 per cent. on £8,709 £610
 8 per cent. on £6,291 503
£1,113

The six months ended 30th June 1928 have to receive credit for :—

7 per cent. on £6,976 £488
 8 per cent. on £10,805 864
 9 per cent. on £8,219 740
£2,092

The six months ended 31st December 1928 have to receive credit for :—

7 per cent. on £4,031 £282
 8 per cent. on £6,074 486
 9 per cent. on £7,621 685
 10 per cent. on £10,542 1,054
£2,507

The profit which it is desired to spread over the period of the agreements should, therefore, in the first instance be carried to a suspense account, and appropriated each

half-year on the above basis. The suspense account will be in the following form :—

NET PROFIT ON HIRE-PURCHASE TRADING SUSPENSE ACCOUNT

1927 June 30	To Transfer to P. & L. A/c 7% on £5,500 „ Bal. carried down ..	£ 385 <u>1,715</u> <u>£2,100</u>	1927 June 30	By Net Profit being 7% on £30,000	£ 2,100 <u>£2,100</u>
Dec. 31	To Transfer to P. & L. A/c 7% on £8,709 8% on £6,291 „ Bal. carried down ..	 610 503 <u>3,642</u> <u>£4,755</u>	Dec. 31	By Balance .. „ Net Profit being 8% on £38,000	 1,715 3,040 <u>£4,755</u>
1928 June 30	To Transfer to P. & L. A/c 7% on £6,976 8% on £10,805 9% on £8,219 „ Bal. carried down ..	 488 864 740 <u>4,953</u> <u>£7,045</u>	1928 June 30	By Balance .. „ Net Profit being 9% on £37,814	 3,642 3,403 <u>£7,045</u>
Dec. 31	To Transfer to P. & L. A/c 7% on £4,031 8% on £6,074 9% on £7,621 10% on £10,542 „ Bal. carried down ..	 282 486 685 1,054 <u>7,280</u> <u>£9,787</u>	Dec. 31	By Balance .. „ Net Profit being 10% on £48,344	 4,953 4,834 <u>£9,787</u>
				By Balance ..	<u>7,280</u>

It will be seen that the balance carried forward to the credit of the account at 31st December 1928 consists of the profit on the instalments not yet due which are included in Example 14:—

Half-year ended	7%	8%	9%	10%
	£	£	£	£
30th June 1929	239	442	659	922
31st December 1929	58	409	561	733
30th June 1930	38	256	299	592
31st December 1930	—	80	245	578
30th June 1931	—	—	214	493
31st December 1931	—	—	—	462
Total £7,280	£335	1,187	1,978	3,780

Having now dealt with all necessary adjustments, it remains to ascertain the figure at which the outstanding instalments can be inserted in the balance sheet:—

	£
Amount of Instalments not due	79,390
Less Specific Reserve for debts known to be doubtful	2,741
	<u>76,649</u>
Less Reserve for Discount to reduce instalments to present value, £76,649 at 6 per cent. for 12½ months	4,790
	<u>71,859</u>
Add Instalments due and unpaid	2,979
	<u>74,838</u>
Less General Reserve for doubtful debts at 5 per cent. on £74,838	3,742
Amount to be inserted in Balance Sheet ..	<u><u>£71,096</u></u>

The detailed accounts might be drawn up in the following form :—

BALANCE SHEET
31st December 1928

£		£
Capital—	Freehold Land and	
Authorised and Issued :	Buildings at cost ..	140,088
150,000 Shares of £1		
each	Fixtures, Fittings and	
150,000	Motor Vans at cost,	
	less Depreciation ..	32,500
Five per cent. First Mort-		
gage Debentures ..	Stock in Trade :	
40,000	As valued by the	
Bank Loan	Company's Officials	15,214
Collaterally secured by		
the issue of £75,000	Debtors ..	£9,216
First Mortgage Debs.		
	Instalments under	
Creditors :	Hire-purchase	
Trade & Misc. £12,486	Contracts, less	
Reserve for cost	Reserves ..	71,096
of collecting		80,312
outstanding		
Hire-purchase	Payments in Advance	3,250
instalments		
2,000		
14,486	Cash at Bank and in	
	Hand	10,140
Profit on Unexpired Por-		
tions of Hire-purchase		
Contracts (a) carried		
forward		
6,780		
Profit & Loss A/c :		
Bal. 1 July, 1928 £6,213		
Add : Net pro-		
fit for the half-		
year ended		
31 Dec. 1928 ..		
7,025		
13,238		
£284,504		£284,504

TRADING AND PROFIT AND LOSS ACCOUNT for the half-year ended
31st December 1928

	£		£	£
To Stock—1st July 1928	14,798	By Sales :		
„ Purchases	119,410	Cash ..	73,998	
„ Gross Profit carried forward	59,642	Credit ..	56,294	
		Hire-pur. ..	48,344	
			<u>178,636</u>	
		„ Stock—31st Dec. 1928	15,214	
	<u>£193,850</u>			<u>£193,850</u>
To Selling Expenses, Salaries, Wages, Advertising, Carriage and Gen. Expenses	38,696	By Gross Profit brought forward	59,642	
„ Interest on Loans : (d) Raised to finance Hire-purchase Sales	2,936			
„ Balance—Net Profit on Cash and Credit Sales ..	£13,176			
Net Profit on Hire-purchase Sales transferred to Suspense A/c (e) (p. 74)	4,834			
	<u>18,010</u>			
	<u>£59,642</u>			<u>£59,642</u>
To Directors' Fees ..	500	By Balance brought down being Net Profit on Cash and Credit Sales ..	13,176	
„ Bad Debts (b) ..	3,758	„ Profit on H. P. Sales transferred from Suspense A/c (c)	2,607	
„ Depreciation ..	1,500			
„ Income Tax ..	2,000			
„ Debenture Interest ..	1,000			
„ Net Profit carried to Balance Sheet ..	7,025			
	<u>£15,783</u>			<u>£15,783</u>

NOTES

£

(a) Profit on unexpired portions of contracts consists of :—

The balance on the Suspense A/c

(p. 74) .. 7,280

Less—

Amount credited

to Profit & Loss

A/c for profit

applicable to

debts regarded

as doubtful .. 500*

£6,780

(b) The Bad Debts consist of :—

Debts written off.. 3,000

Add—

Specific Reserve for doubtful debts

31st Dec. 1928.. 2,741

General Reserve for

Doubtful Debts

31st Dec. 1928 3,742

9,483

Less—

Reserve at 30th

June 1928 .. 5,725

£3,758

(c) Profit on hire-purchase sales transferred from Suspense Account is made up as follows :—

Profit applicable to

hire-purchase in-

stalments accrued

due during the

half-year (p. 73) 2,507

Additional credit for

profit applicable

to debts regarded

as doubtful .. 500*

£3,007

Less—

Amount credited to

Profit & Loss A/c

at 30th June 1928

in respect of doubtful

debts now

written back .. 400

£2,607

* The adjustment of the profit credited to the profit and loss account (£500) in respect of doubtful debts is considered in Chapter VII.

NOTES

£		
(d) Interest on loans consists of :—		(e) The net profit on hire-purchase sales has been taken at 10%. Accountancy problems affecting the determination of this figure are considered in Chap. IV.
Interest on Bank Loan for the half-year	1,746	
Add—		
Reserve for discount on outstanding instalments 31st Dec. 1928 to reduce to present value (p. 75) ..	4,790	
	<u>6,536</u>	
Less—		
Reserve for discount 30th June 1928	3,600	
	<u>£2,936</u>	

It will be observed that when the accounts are prepared in the above manner, the following items are clearly shown :—

- (i) The total selling value of goods supplied to customers on hire-purchase terms during the period.
- (ii) The rate of gross profit on which selling prices have been based during the period.
- (iii) The ratio of stock on hand to sales.
- (iv) The ratio of selling expenses to sales.
- (v) The cost of financing hire-purchase sales in the shape of interest on loans after adjustment for discount on outstanding instalments. The discount reserve is, in effect, a provision for future loan interest, and the net amount charged in the profit and loss account represents the cost (both present and future) of financing the sales for the period, the gross profit on which is credited to the account.

- (vi) The charge to the period for bad and doubtful debts.
- (vii) The proportion of profit on hire-purchase sales applicable to the period.
- (viii) The present value of outstanding hire-purchase instalments available as security for loans which it may be desired to raise in order to finance the business.

It will subsequently be shown that when the books are kept on what is commonly known as the "Stock System" much of this information is not available unless supplementary statements are prepared.

When preparing condensed accounts for publication careful consideration should be devoted to the amount of detail which is included; a suggestion is made on page 103 that if such accounts are to serve a useful purpose the full profit on hire-purchase transactions should be credited to the profit and loss account, and that the amount which is carried forward in suspense to future years should be transferred by way of an appropriation to a general reserve account. The method of determining that amount and the ultimate effect on profits do not differ in substance from those explained in this chapter, but they have an important bearing on the value of the published accounts to shareholders.

CHAPTER IV

TREATMENT OF PROFIT ON HIRE- PURCHASE SALES

INTRODUCTORY REMARKS.

THREE METHODS OF TREATING THE TRADING PROFITS.

RELATIVE MERITS OF FIRST AND SECOND METHODS.

THIRD METHOD.

DETERMINATION OF PROFIT :

(a) INSTALMENTS INCLUDED IN BALANCE SHEET AT FULL
VALUE.

(b) CASH PORTION OF INSTALMENTS TREATED AS AN ASSET.

(c) PRESENT VALUE OF INSTALMENTS TREATED AS AN ASSET.

APPORTIONMENT OF PROFIT OVER LENGTH OF AGREE-
MENTS.

DEFERRED PAYMENT SALES.

ATTITUDE OF INCOME TAX AUTHORITIES.

EFFECT OF APPORTIONMENT ON PUBLISHED ACCOUNTS.

IV.—TREATMENT OF PROFIT ON HIRE-PURCHASE SALES

Introductory Remarks

IT will be apparent from the previous chapter that the treatment of hire-purchase sales in the books of a business involves consideration of several important accountancy principles.

When a retailer buys an article for £10 and sells it to a customer for £15, it does not require much bookkeeping to tell him that he has made a gross profit of £5. But when he sells the same article for £1 down and 14 monthly payments of £1, there may be some doubt in his mind as to what profit arises from the transaction.

He will readily understand that over a period of 15 months he receives for the sale of the article an aggregate amount of £15, so that at the end of the time he is in pocket to the extent of £5, but he will naturally ask whether the whole £5 is profit and when he may consider the profit is earned. Before these questions can be answered satisfactorily, the principles involved must be properly understood.

It will be found in practice that there are a number of ways of dealing with the profit on a hire-purchase sale, which, although differing in points of detail, on examination resolve themselves into three main groups which may be distinguished as follows:—

1. To make no distinction between a hire-purchase transaction and an ordinary cash or credit sale, profit being regarded as earned when goods are delivered to a customer.
2. To spread the profit over the length of the agreement.

3. To credit the profit to the period in which the contract is completed by payment of all instalments.

Nearly all retailers engaged in hire-purchase business at the present time adopt either method 1 or 2. There is unfortunately no uniformity even among companies which publish their accounts, and it is sometimes found, owing to the condensed form in which balance sheets are issued, that no indication can be obtained of which method has been adopted. Without this information it is difficult to form a reliable opinion of the prosperity of a business, as the two methods lead to widely different results.

Relative Merits of First and Second Methods

When it is remembered that a customer usually has an option to return goods at any time during the currency of his agreement, and so cancel the sale and reduce or even nullify the profit, readers may not unreasonably suggest that the first method is contrary to recognised accounting principles. It is accordingly necessary at the outset to understand clearly the grounds on which exponents of the method seek to justify the practice of crediting to the trading account a profit which has not been, and which in certain eventualities never will be, realised.

Those who support the practice contend that, viewed from a commercial and popular standpoint, hire-purchase transactions are sales of goods; that the system has been introduced to meet the needs and convenience of customers; that when customers select goods they regard the transactions as purchases for which payment is to be made by instalments; and that they rarely have any intention of returning the goods. That there is much to be said for these contentions is shown by the small percentage of cases in which goods are returned at a customer's option.

Some retailers, therefore, take the view that it is not

contrary to commercial morality to treat the profit on such transactions as having been earned when the agreements are signed. The fact that legally no sales take place, and that the retailer is still vested with the title to the goods, is merely a state of affairs which has been created to safeguard hire-purchase traders by giving them a legal claim on the goods, and should not affect the treatment in accounts. They recognise the necessity for adequate reserves against doubtful debts and contingencies, but do not admit that in this respect hire-purchase sales need be treated differently from ordinary credit sales.

Objection to the practice is raised on the ground that while, in the case of an individual sale, the above arguments may be sound, yet if followed on a large scale the effect is financially imprudent. In times of trade depression, industrial strikes, or national upheaval, a large proportion of goods forming the subject of hire-purchase agreements might be returned to retailers. The resultant accumulation of repossessed articles, coupled with a lessened demand for new goods, would be likely to involve them in heavy losses, and unless they had adequate reserves the effect would be to intensify their financial difficulties.

A further objection is that the course is liable to impoverish the finances of a business selling goods on two and three year agreements, because in such cases a part of the profits would not be received in cash until a considerable time had elapsed after the sales were made. The importance of this consideration will vary in different businesses, but a preponderance of long-term agreements does give rise to the danger of dividing profits which have not been realised in cash. An unnecessary strain, which may necessitate having resort to borrowing, is thereby imposed on the finances of the business. If, owing to cancellation of agreements, the profits never become

available for distribution, it might be found in an extreme case that dividends have been paid out of capital.

Those who advocate the practice do not deny these risks but consider that they should be met by following a conservative financial policy. Adequate reserve funds should be built up by appropriations from profits, rather than by understating the annual profits, as would be done, they contend, if the profit on hire-purchase sales were spread over the length of the agreements.

It will be appreciated that the subject gives room for wide divergence of opinion, and although it has lately attracted much attention, it seems unlikely that general agreement will be reached. The method adopted in a business where hire-purchase sales form less than half of the turnover might not be suited to one whose activities are confined to that class of trade, and it will be understood that this circumstance might have an important bearing on inconsistencies which are apparent as between individual cases. Mail-order sales attracted through the medium of advertisements in the daily press, whereby anything from a tennis racquet to a wireless set can be obtained on payment of five shillings down, naturally call for different treatment from that which would be accorded to the sales of a store where customers are interviewed and their credentials can be examined, and it would probably be considered essential to create very heavy reserves before profits could be said to arise from sales such as those first mentioned. The class of goods sold may sometimes necessitate a particular treatment of the profit. For example, when electrical or wireless apparatus is sold, it may be unwise to take immediate credit for the whole profit owing to the risk of new inventions quickly rendering goods obsolete and thus tending to a high proportion of cases in which customers exercise their option to terminate their agreements. In such cases it

may be better for the retailer to sell on deferred payment contracts and thus avoid the risk of having goods returned.

Attempts have been made to argue that because the transactions are not legal sales, they cannot result in a profit until ownership of the goods passes to customers. If the legal position is relied upon, however, it is difficult to oppose a suggestion to treat the whole of the instalments as hire, which legally they are, and to credit them in full to the trading account. Such treatment would lead to a gross misstatement of the position of affairs unless a proportionate part of the cost of the goods is debited to the trading account as a reserve for the loss which will arise when customers exercise their options to acquire the goods. This presupposes that the options to acquire will be exercised.

The objection which was raised to the practice of taking immediate credit for the whole of the profit on hire-purchase sales was that customers usually have an option to return goods and that completion of sales is by no means certain. In the face of this objection, it would be inconsistent to require a reserve to be created for losses which can only be sustained when customers complete their agreements.

The practical solution seems to be to assume, as was done by Mr. Justice Rowlatt in *Drages Ltd. v. Commissioners of Inland Revenue* (see page 192), that customers will normally complete their agreements by paying the instalments and obtaining the right to the goods, in other words to regard the transactions for all commercial purposes as being sales of goods.

The balance of opinion appears to be that no hard and fast rule can be laid down, and that the method of dealing with profits must depend upon the particular circumstances and financial policy of each business house.

Third Method

Crediting the profit on hire-purchase sales to the periods in which contracts are completed by payment of all instalments represents the height of financial prudence, and most nearly accords to the legal view of hire-purchase, but unnecessarily restricts the divisible profits while a business is in a state of development.

Before a profit and loss account can be prepared, it is necessary to extract the sale price for all agreements where payment has been completed since the date of the last accounts, and to prepare an analysis as between the various trading periods in which the agreements were signed in order that the appropriate rates of profit may be calculated on the sales in question. Strict adherence to the method might cause the profit on a sale to be held in suspense long after the majority of the instalments had been paid because of difficulty in collecting the last payment, and divisible profits would fluctuate according to the receipt of instalments rather than according to the volume of sales. The method is thus commercially inferior to the first two, and is not a course which is frequently adopted except in a limited number of cases where completion of contracts by customers is a matter of much uncertainty.

Determination of Profit

The foregoing remarks have reference to the treatment of the profit on hire-purchase sales, but it has yet to be seen what is the measure of that profit. Returning to the simple example at the beginning of this chapter, we have to consider whether the gross profit of £5 is subject to any adjustment before it can be dealt with by one of the methods mentioned above.

The balance sheet of a hire-purchase trader usually

shows as an asset the future instalments due from customers, and upon the value of this asset depend certain adjustments of the gross profit. The principles governing the determination of the trading profit can therefore best be explained by considering three alternative methods of showing the outstanding instalments in the balance sheet. It is assumed in each case that adequate provision for bad and doubtful debts is made on the basis outlined elsewhere in this volume :—

(a) To include the outstanding instalments in the balance sheet at their full value, subject to a reserve for doubtful debts.

When the instalments are included in the balance sheet at their full value, the effect is to ignore entirely the fact that, at the date of the balance sheet, the instalments would not realise the value placed upon them. Payment of a large part could not be enforced for perhaps 12 months or more, and no reserve exists for the consequent loss of interest, nor for the cost of collecting the instalments, which in certain cases may involve no inconsiderable expense.

The effect is therefore to overstate the profit on the hire-purchase sales, but it would probably be of little importance in the case of businesses having a small proportion of hire-purchase trade, and it is only in such cases that the method can be employed without serious objection.

(b) When goods are marked at cash prices and interest is added for hire-purchase prices, to spread the interest rateably over the period of the agreements. The outstanding instalments are included in the balance sheet at their full value subject to deductions for unearned interest and doubtful debts reserve.

When goods are marked at cash prices and interest is added for hire-purchase prices, the profit which is credited to the trading account at the time of a sale is only the difference between cost and the cash sale price. The interest is segregated in the books, though not on the customers' accounts, and credited to the profit and loss account as instalments fall due.

At the date of the balance sheet there will be held in suspense, to be carried forward to future periods, a certain amount of interest which should be deducted from the outstanding instalments; the balance will then represent the proportion of the cash price of the goods which has not fallen due for payment. Thus the instalments are included in the balance sheet at something less than their full value, thereby meeting one of the objections to method (a).

It will be shown in Chapter VI that when method (b) is followed, the interest is usually apportioned on a flat rate basis, and that a secret reserve is thereby created, owing to the profit and loss account being under-credited in the earlier months. The amount of the secret reserve will naturally vary according to the length of the agreements and the rate of interest charged, but in particular cases it may amount to nearly $4\frac{1}{2}$ per cent. on the outstanding instalments, and may therefore be regarded as covering to an extent the cost of collecting the instalments, failure to reserve for which was the second objection to method (a); whether it is entirely adequate would have to be decided in each case.

Hence by apportioning the interest at a flat rate over the length of the hire-purchase agreements, a result is reached which might be regarded as approximately correct without introducing unnecessary calculations. The adaptation of the bookkeeping system to give effect to this method will be considered later.

- (c) When goods are marked at hire-purchase prices, to create a reserve for discount on instalments which have not become due. The outstanding instalments are thus included in the balance sheet at their present value (which is less than their full value) subject to a reserve for doubtful debts.

This method does not differ in substance from (b). The calculation of discount on the instalments to reduce them to their present value has already been explained on page 70. It should be observed, however, that when the reserve is accurately calculated, there is no secret reserve such as exists when the previous method is adopted, and if the accounts are to show the true profits, further provision is necessary to cover the cost of collecting the outstanding instalments.

It will thus be seen that the outstanding instalments should not be included in the balance sheet at a higher figure than they would realise after providing for interest on the money which is temporarily locked up and paying all expenses attendant on their collection, such as wages of office staff, solicitors' costs, and travelling. These are just as much expenses chargeable against the sales as are loan interest, wages, legal charges, &c., which have been paid during the trading period. If the business were closed down, the outstanding instalments could not be collected without incurring these expenses during the period of realisation, and they should be provided for in the accounts quite independently of any apportionment of the trading profits over the period of agreements. That is to say, before the profits can be apportioned, full reserves must be created to reduce the outstanding instalments to their realisable value at the date of the balance sheet, a step which is essential if the true profit on hire-

purchase sales is to be determined. To leave the expenses to be charged in the accounts when they are paid is to confuse the position so that the true profit-earning capacity of the hire-purchase trade cannot be ascertained.

Apportionment of Profit over Length of Agreements

To apportion the profit on hire-purchase sales over the length of agreements (Method 2 above) is so frequently regarded as the best treatment that the full consequences should be thoroughly understood.

When a business sells for cash as well as on hire-purchase terms, it is necessary to keep careful detailed records and separate trading accounts for each class of transaction if the profit on the hire-purchase sales is to be correctly determined. It may be thought that sufficiently accurate apportionments can be made by basing calculations on the combined profits of the whole business, but such an expedient would be unsatisfactory when the gross profit on the hire-purchase sales is higher than that obtained on the rest of the trade.

Then it will have to be decided whether the gross or net profit is to be apportioned. If the former, and the turnover consists principally or entirely of hire-purchase sales, it may be that no divisible profits will be shown during the first year or two of the operations of a new business. When rapid expansion is taking place in the trade of an established concern, the increase in profits may be negligible until the turnover becomes stable again. This may be illustrated by two examples:—

Example (a). New Business.

	Year 1	Year 2	Year 3
Hire-purchase Sales	£ 100,000	£ 100,000	£ 100,000
Gross Profit before apportionment	36,000	36,000	36,000
Expenses	25,000	25,000	25,000

Example (b). Expanding Business.

	Year 1	Year 2	Year 3	Year 4	Year 5
	£	£	£	£	£
Hire-purchase Sales ..	100,000	100,000	100,000	150,000	200,000
Gross Profit before apportionment ..	36,000	36,000	36,000	54,000	72,000
Expenses ..	25,000	25,000	25,000	32,500	40,000

In the first example, the amount of gross profit to be apportioned to the first year will depend upon the length of the agreements. If they are all for periods of three years, something less than one-third of the profit will accrue; but as some may be for shorter terms, the amount may be placed at £18,000. This sum is insufficient to cover the expenses, so that the accounts for the first year will show a loss. The effect on the second year will be mitigated by the profit accruing on the first year's contracts which falls to be credited to the second year, so that the accounts as finally published might show a small profit. It is not until the third year that the profits will represent a normal year's working.

The second example is that of an established business where trade is expanding. The third year is a normal one and shows a gross profit of £36,000 (partly from the current year's sales and partly from sales made in the two previous years), expenses £25,000 and net profit £11,000. In the fourth year, although the gross profit on the additional sales amounts to £18,000, only a part falls to be credited to that year as having been earned, and the balance is carried forward. The amount to be credited to the year will depend upon the length of the agreements and may be placed at, say, £7,500. It will be seen that this sum is only just sufficient to cover the additional expenses which were incurred in obtaining the increased turnover, and the net profit available for distribution

remains stationary. The same effect will be felt in the fifth year, and not until the rate of increase in the turnover diminishes will any benefit accrue to the net profits unless a reduction in the ratio of expenses can be secured.

It should be noticed that a combination of the two examples, that is to say, a new business with an expanding turnover and increasing expenses, would accentuate the apparent loss in the earlier years.

These difficulties would be avoided by apportioning net profits over the length of the hire-purchase agreements, but on the other hand it may be no easy task (particularly when the trade is not confined to hire-purchase sales) to determine with any degree of accuracy what is the net profit on the hire-purchase transactions. Questions will arise as to whether certain expenses should be debited before or after making the apportionment, and, when the trade is mixed, what proportion should be charged against the hire-purchase sales. A certain large company, whose activities are confined to hire-purchase sales, deducts the whole of its expenses before striking the balance of profit to be apportioned.

It is suggested that if it is desired to adopt the principle of apportioning net profits over the length of hire-purchase agreements, there can be no objection to charging against profits, before making the apportionment, all selling expenses of the business, including salaries and wages, advertising, carriage, general office expenses and interest on loans raised to finance the hire-purchase sales. Expenses which have no connection with turnover and which have to be met irrespective of trading conditions should, however, be charged against the net profits applicable to the year of account. Examples of such expenses are directors' fees, depreciation, income-tax and debenture interest.

The next question to be considered is how the profits

are to be apportioned over the length of the hire-purchase agreements. It is obviously impracticable to treat each sale separately, and it is usual to apportion the total gross or net profit for each year. For this purpose the Running Summary of Instalments falling due (Example 5) will be found invaluable, as the exact proportion of a year's sales which falls due for payment during that year can be easily ascertained. The method of calculating the apportionment of the profits was dealt with on page 73. Rough and ready calculations are liable to be misleading. It is a natural inclination to assume that if the turnover of a business is confined to sales on three year agreements, one-third of the profit on a year's turnover accrues in that year. Such an assumption ignores the fact that the sales do not all take place in the first month, and if they are spread equally over the whole 12 months of the year, only one-sixth of the profit actually accrues in the first year.

It is sometimes found that profit on hire-purchase sales is apportioned on the basis of instalments received instead of instalments falling due. The principle involved is that until cash has been received there is no profit available for distribution. The same principle applies also to ordinary credit sales, but such debts are usually paid within a short time, whereas there may be difficulty in collecting overdue hire-purchase instalments. On the other hand, the instalments outstanding for any length of time beyond the due date should not in the ordinary course be so large in proportion to the total turnover as to make the results obtained by this method very different from those shown when the profits are apportioned on the basis of instalments falling due. A certain amount of extra work is necessary to distinguish cash received in respect of each year's sales, and the method does not appear to possess any marked advantage over those already described.

At the same time, the underlying principle is sound, and as such must not be ignored.

Enough has been written to show that while it may be financially prudent to spread the profit on hire-purchase sales over the length of agreements, the methods of doing so are not free from complication and require careful attention if reliable accounts are to be kept.

The subject may become of very great importance when certain persons have a right to participate in the profits, as, for example, where a manager is entitled to a commission, or where participating preference shares have been created. Varying conditions are usually attached in such cases; the manager might be entitled to commission only when the profits exceeded those of the previous year, or there might be a stipulation that a loss incurred in a year was not to be carried forward against profits of future years; participating preference shares are entitled, in addition to a fixed cumulative preferential dividend, to a further dividend which may either be payable only in any year when a stated dividend has been paid on the ordinary shares, or only when the profits of any year exceed a stated percentage on the total capital of the business. The additional dividend is not cumulative and is dependent upon the profits of each year. It will be evident that, by creating secret reserves in one year and writing them back in the following year, it would be possible so to regulate the amount of profits that the participating rights of the preference shares were affected. When the right to share in profits is cumulative and does not depend upon the earning of a minimum profit, the matter may be of less importance, because then the benefit of profits carried forward will accrue in a following period. It is obvious, however, if disputes are to be avoided, and in fairness to the parties concerned, that in all cases the exact method of determining profits should

be clearly defined, as to whether the balance is to be struck before or after carrying forward the proportion of profit applicable to unexpired agreements, how that proportion is to be ascertained, and how the expenses of the business are to be treated.

Deferred Payment Sales

Although there is a wide legal distinction between hire-purchase and deferred payment sales, from an accountancy point of view there is little practical difference. While, therefore, the profit on deferred payment sales can be treated as available for immediate distribution, yet such a course is open to the same objections as were advanced against this policy in the case of hire-purchase sales, and the whole of the foregoing remarks, apart from those on the legal aspects of hire-purchase sales, may be taken as being equally applicable to deferred payment sales.

Income Tax

This chapter would not be complete without a reference to the attitude of the income-tax authorities. The general practice at the present time is explained in Chapter IX, and failure to ascertain that the method adopted for dealing with the profits will be acceptable may lead to considerable difficulty in settling assessments.

Effect on Published Accounts

The questions discussed in this chapter are of marked importance in the case of public companies, as it is very desirable that shareholders and investors should know what profits are earned by companies in which they are interested, and that balance sheets prepared for their information should enable a comparison to be made of the achievements of different companies which are engaged in the same class of business.

If clarity were the sole objective when preparing accounts for publication, method 1, on page 83, would provide the most suitable treatment for the profit on hire-purchase sales, as it has the advantage of clearly disclosing the trading results. Apportionment of profits over several accounting periods in accordance with method 2 is liable to conceal the trend of the business, as the following example serves to show:—

Profits before apportionment:—

Year 1	..	..	..	£50,000
„ 2	..	..	..	60,000
„ 3	..	..	..	80,000
„ 4	..	..	..	75,000
„ 5	..	..	..	65,000

Let it be assumed that the whole of the sales are on two-year contracts, and that the volume of the turnover is regular throughout each year. Then if the profits are spread over the length of the agreements, the accounts placed before the shareholders will show:—

Year 3	..	..	..	£62,500
„ 4	..	..	..	73,750
„ 5	..	..	..	73,750

arrived at as follows:—

Year 3— $\frac{1}{4}$ of £50,000	..	£12,500
$\frac{1}{2}$ of £60,000	..	30,000
$\frac{1}{4}$ of £80,000	..	<u>20,000</u>
		<u>£62,500</u>

Profit carried forward in suspense .. £75,000

Year 4— $\frac{1}{4}$ of £60,000	..	£15,000
$\frac{1}{2}$ of £80,000	..	40,000
$\frac{1}{4}$ of £75,000	..	<u>18,750</u>
		<u>£73,750</u>

Profit carried forward in suspense .. £76,250

Year 5— $\frac{1}{4}$ of £80,000	..	£20,000
$\frac{1}{2}$ of £75,000	..	37,500
$\frac{1}{4}$ of £65,000	..	<u>16,250</u>
		<u>£73,750</u>

Profit carried forward in suspense .. £67,500

It will be observed that if only the adjusted profits are stated, the effect in the third, fourth and fifth years is to make it appear that profits are increasing or being maintained when, in fact, there is a steady decline. Nor does the amount of profit carried forward in suspense enable a calculation to be made of the exact profit before apportionment, for while an increase or decrease in the amount may afford an indication of the tendency of the profits, it is by no means a reliable guide, as it will be seen that the published profits and suspense account both show an increase in year 4 over year 3, whereas profits before apportionment declined.

The creation of secret reserves is now very common and it has become so usual to draw on them in lean years as hardly to admit of criticism. A discussion of the ethics of the practice is beyond the scope of this book, but so long as it is tolerated and published accounts are prepared with a view to showing profits free from violent fluctuations, the levelling up of trading results in the foregoing manner cannot be successfully opposed.

To summarise the merits of the two methods, it can be said that the first discloses the true trend of the profits, which may be concealed by the second method unless the accounts give full information. On the other hand, the second automatically helps to create a strong financial

position by keeping in reserve profits which otherwise might be distributed as dividend.

It has been shown that hire-purchase transactions are legally no more than the hiring of goods for a fixed period with an option to acquire the goods outright at the end of the period of hire. They are therefore quite distinct from sales of goods yet it is probable that, in the minds of both public and retailers, the difference is regarded as of small importance. Deferred payment sales, although resembling hire-purchase transactions in that payment is made by instalments over a period, are nevertheless legal sales which involve an immediate transfer of legal ownership of the goods.

When advising upon the correct treatment of hire-purchase transactions or deferred payment sales for accountancy purposes, the considerations which have to be borne in mind may be divided into :—

(a) Legal ; and (b) Commercial.

In law no sale takes place and no profit arises on a hire-purchase transaction until the customer has exercised his option to acquire the goods, but a deferred payment sale can result in an immediate divisible profit.

Commercial prudence dictates that profits should not be divided to an extent which is likely to impoverish the finances of a business, a policy which applies with equal force whether the business sells on hire-purchase or deferred payment terms.

Commercial morality requires that the published accounts of a business should disclose the result of the trading year by year in a form from which shareholders can judge of the value of their shares.

Between these conflicting principles the accountant has to find a practical compromise, and it is only natural that

there should be differences of opinion as to which is the most desirable.

Strict adherence to the legal view would cause the profit on hire-purchase sales to be held in suspense until payment of final instalments, and, in the case of a company whose revenue was derived solely from hire-purchase business, its dividend-earning capacity might be severely taxed. Apportionment of profits on hire-purchase and deferred payment sales rateably over the period of agreements results in the creation of large reserves and, unless clearly explained in the accounts, tends to obscure the trend of the profits; but if no apportionment is made, profits are shown as available for distribution which may not be realised in cash for a comparatively long time.

So much must depend upon the circumstances of each case that it is difficult to suggest a solution which will be of universal application, but the following course is advanced for consideration.

The profit credited to profit and loss account should be that arising on the turnover for each year of account.

Before the question of apportioning a profit over a period can be considered, it is necessary to be assured that the profit is a net one, which implies that all ordinary working expenses must be charged in the period to which they relate. Any interest payments must similarly be debited against the period to which they refer; a proper reserve must be made for doubtful debts, with a margin for contingencies; some allowance must be made for loss of profit in cases where goods will be returned (based on past experience); further, the cost of collecting future instalments receivable must be taken into consideration, as well as interest on the capital locked up in such instalments.

When the above points have been considered and dealt

with, a figure of *net* profit is ascertainable, and it is submitted that it would not be unfair or imprudent to consider this as being earned at the moment when the agreements are entered into with customers. After all, the main function of a hire-purchase business is to attract or search out suitable persons to acquire goods by instalments just as the main function of a retail tradesman is to induce a customer to purchase his goods, either for cash or on short credit.

Objection may be urged against the practice of taking credit for the profit at the moment when agreements are entered into, on the ground that, as the cash would only be received by instalments over a period of, say, one or two years, it is not a realised profit. Somewhat similar circumstances are not uncommon in trading enterprises where debtors are numerous, although, as the term of credit would be short, the matter is, relatively, of smaller importance. To express the point in another manner, part of the necessary floating capital with which a hire-purchase business requires to be equipped is represented by trading debtors. If the floating capital is insufficient, then it is clear that it would be inexpedient, and might even be impossible, to provide funds to enable the balance at the credit of profit and loss account at the end of a year to be distributed in dividend. In such an event it would seem that the proper practice in drawing up the balance sheet at the end of the year would be to debit the profit and loss account with an appropriation to general reserve account, thus retaining, to that extent, funds in the business. There would then remain a credit balance on the profit and loss account which could presumably be distributed in dividend.

The amount to be transferred to the reserve account would be calculated in accordance with the principles already explained, the only modification being that the

suspense account shown on page 74 would no longer be kept in the private ledger but would be a memorandum account. Fluctuations from year to year in the amount required to be carried forward at the credit of the reserve account would be adjusted by transfers to or from the profit and loss appropriation account, a suitable explanation being given of the circumstances which necessitate the adjustment.

By way of illustration the *pro forma* profit and loss account on page 77 may be redrafted in the following form :—

	£		£
To Directors' Fees ..	500	By Net Profit on trading	
„ Income Tax ..	2,000	after charging all	
„ Debenture Interest ..	1,000	expenses including	
„ Transfer to General Reserve Account ..	2,227	bad debts and depreciation ..	12,752
„ Net Profit carried to Balance Sheet ..	7,025		
	<u>£12,752</u>		<u>£12,752</u>

The transfer to general reserve account consists of the difference between the net profit on the hire-purchase sales for the period—£4,834—and the amount apportioned to the period of account—£2,607.

The balance sheet and profit and loss account then show clearly the profit for the period as well as the amount (if any) carried forward to future years in respect of unexpired agreements, and the extent to which the divisible profits have been depleted or augmented by transfers to or from the reserve account.

CHAPTER V

METHODS OF FINANCING HIRE- PURCHASE TRADE

NEED FOR WORKING CAPITAL.

BILLS OF EXCHANGE.

BANK LOANS.

FINANCE COMPANIES.

COMPARISON OF THE THREE METHODS.

V.—METHODS OF FINANCING HIRE-PURCHASE TRADE

Need for Working Capital

ADEQUATE working capital is essential to every business, and without it trading can neither be commenced nor continued. By the judicious employment of capital, advantage can be taken of discounts for prompt payment, and purchases can be made at favourable prices for cash on delivery. On the other hand, it is not economical to maintain credit balances in excess of requirements, nor to have available large sums which cannot be remuneratively employed. The ideal state of affairs is to secure a regular turnover of stock on terms which will assure a steady inflow of cash against necessary payments.

In businesses engaged in hire-purchase trading, current resources are frequently taxed by demands for facilities which necessitate credit being granted to customers for comparatively long periods. Every increase in turnover necessitates an increase in purchases, which in turn quickly involves heavier payments. There is no corresponding inflow of cash ; the additional sales merely create further debts due from customers which will be received in small instalments over extended periods.

The tendency in all healthy businesses is towards an expansion of turnover, and as a consequence every successful hire-purchase trader is faced with a growing accumulation of long-term debts among his assets. Financing this class of trade thus calls for a steady supply of fresh capital, somewhat analogous to a running credit, which can be regulated according to fluctuations in the hire-purchase debts.

New permanent capital usually has to be raised at one

time and in one large amount, a course which is not economical when it results in a temporary supply of cash in excess of immediate requirements. Further, on account of the various rights and interests which may be involved, it is not always expedient to increase the permanent capital of a business. Other means of financing the trade are frequently sought, and it is proposed here to explain three methods of financing hire-purchase sales which are in common use, the first by bills of exchange, the second by bank loans, and the third by finance companies.

Bills of Exchange

When sales are for substantial amounts to persons of good financial status, a method of raising temporary capital which may advantageously be employed is that of drawing bills of exchange on customers for the amounts of their instalments.

Separate bills are drawn to mature as each instalment falls due. They are accepted by customers at the time of signing the hire-purchase contracts, and can be discounted by the trader with his bank at any time before they fall due, thus providing him with an immediate supply of cash. In order to facilitate this operation, it is usual for the customers' acceptances to be recognised by the trader's bank, which can generally be arranged when the customers are themselves traders or manufacturers acquiring, for example, machinery, railway wagons, or motor vehicles. In other cases, it is more usual to obtain bank loans and to deposit the bills as security, supported, perhaps, by a mortgage of the business premises.

In the hire-purchase agreements with customers it should be clearly stated that the bills are drawn as collateral security for the instalments and do not operate

as payment until they are met by the acceptor ; otherwise the seller may discover that he has no right to recover the goods in the event of dishonour of a bill on maturity. A suitable clause to be inserted in the agreement is as follows :—

Simultaneously with the execution of this Agreement the Hirer agrees to execute and deliver to the Owners 23 Bills of Exchange each for the sum of £10, and payable on the 3rd day of September 1929 and of each succeeding month and bearing interest after maturity until paid at the rate of 7 per cent. per annum, such Bills of Exchange to be given and received not as payment of the said monthly hire due under Clause 1 hereof but as collateral security for the due payment thereof, provided that if the Owners retake possession of the said articles under the powers conferred on them by Clause 8 hereof, or if the Hirer returns the articles under Clause 7, the Hirer shall not be liable in respect of any Bills of Exchange falling due for payment after such happening.

A case on this point came recently before the Court of Appeal in Northern Ireland. The customer had given a trader bills of exchange for monthly instalments of a hire-purchase debt as collateral security under the terms of a written hire-purchase agreement. The bills were discounted by the trader and the customer became bankrupt before the whole of the bills had fallen due for payment. It was held that the property in the goods had not passed to the customer, as neither the acceptance of the bills nor the discounting of them by the trader operated as payment of the instalments. (*In re Rankin & Shiliday* (1927), N. Ir. 162 C.A. (Ir.).)

When a bill has been discounted and is subsequently dishonoured by a customer at maturity, the trader becomes

liable to the bank as drawer and endorser. Thus responsibility for bad debts rests entirely upon the trader, and adequate reserves to meet such losses must be maintained. His balance sheet should, therefore, contain a reference to the contingent liability on bills discounted and not matured. The instalments will not, of course, appear as an asset, since the customers' accounts will have been balanced by the proceeds of the discounted bills, the bank charges thereon having been debited to profit and loss account.

Bank Loans

Another method, and one which will commend itself to the average trader more readily than the first, is that of obtaining a loan or overdraft from his bank.

Little difficulty is likely to be experienced in obtaining advances against valuable business premises or other first-class security. An arrangement of this nature, however, is not always sufficiently elastic, since the hire-purchase sales may grow to such an extent that the security falls short of the advances required. To overcome this disadvantage loans may be raised on the security of the hire-purchase debts, but before granting facilities the bank may wish to make stipulations affecting the conduct of the business, such as the length of credit allowed to customers or the classes of goods which may be comprised in sales coming within the arrangement.

When loans are so raised it is necessary for the trader to execute a general assignment of the agreements to the bank. Periodically, those which have been completed are deposited with the bank and an advance obtained for a sum equal to an agreed percentage—say 75 per cent.—of the total sum payable by customers. Precise details

naturally vary, but the following arrangements are typical :—

1,000 agreements, each for 12 monthly instalments, amounting in total to £2,300 per month	£	
		<u>27,600</u>
Amount required, being 75 per cent. of the instalments		20,700
Less First month's instalments		<u>2,300</u>
<i>Net amount advanced</i>	£	<u>18,400</u>

or

1,000 agreements as above	£	27,600
Less First month's instalments		<u>2,300</u>
		<u>£25,300</u>
<i>Amount advanced being 75 per cent.</i>	£	<u>18,975</u>

The trader will probably be appointed agent of the bank for the purpose of collecting the instalments falling due, and all sums received will be applied in reduction of the advances. Should it become necessary to enforce the security, the bank, through being in possession of the hire-purchase agreements, and by virtue of the general assignment executed by the trader, can revoke his authority to act as their agent and require payment of instalments to be made direct to themselves.

It is unlikely that the bank will advance up to the full amount of the instalments, as a margin will be required for possible bad debts, and the first obvious effect of this limitation is that, whereas the bank has advanced, say, only 75 per cent. of the instalments payable under an

agreement, the whole of the instalments as collected will be applied in reduction of the general indebtedness of the trader, so that his cash position does not benefit by the remaining 25 per cent. This objection can be overcome, however, by adopting a scheme similar to that outlined in connection with private finance companies in Chapter VI, the effect of which is, shortly, that when the amount advanced in respect of a particular agreement has been repaid, any further instalments received in respect of that agreement are retained by the trader. An arrangement of this nature is also of assistance to the bank, as it shows clearly what security is available for the loan, that is to say, what is the amount of unpaid instalments as distinct from merely the gross amount of the agreements.

Losses by default of customers will fall on the trader, and thus it will be necessary for him to maintain an adequate reserve for bad debts. In his balance sheet the unpaid instalments will be shown as assets, the outstanding balance of advances by the bank appearing as a liability with a note to the effect that they are secured by an assignment of hire-purchase agreements.

Finance Companies

In recent times much has been heard in England of the American method of financing hire-purchase business by means of companies specially formed with that object. These companies fulfil very useful functions and generally render great assistance to hire-purchase traders.

They endeavour to standardise the terms on which different commodities are sold and to ensure that the principles of sound hire-purchase trading are observed by retailers. They do not in any way compete with retailers or attempt to usurp their functions; rather do they co-operate with them and assist in bringing hire-purchase

transactions to successful conclusions, thereby helping to popularise the system. They are in a position to set up and maintain the organisation necessary to compile statistics bearing on various aspects of hire-purchase trading, thus enabling them to conduct their business on scientific lines and to supply traders with the best possible financial service. Their operations usually extend over a much wider geographical area than those of retailers, and consequently they are less likely to be seriously affected by local economic disturbances, such as unemployment, which might seriously affect a business confined to one district. Partly for this reason they are in a better position than retailers to meet losses through bad debts.

Before agreeing to finance a trader's sales, a finance company will require a knowledge of his business reputation. A trader who aims to please his customers and make them feel satisfied with their purchases is more likely to be acceptable to the finance company and occasion less difficulty in collecting instalments than one whose policy is to sell something with little regard to subsequent events. Of particular importance in this connection is the "after-sales service" inaugurated by some retailers in regard to motor-cars, pianos, and similar articles which may require frequent attention and maintenance. When a trader is prepared to maintain the car in running order for a period or tune the piano free of charge to the customer, there is an inducement to the latter to be prompt in paying his instalments, and the trader's business is correspondingly attractive to the finance company.

Having satisfied the finance company as to these general features of his business and arranged the terms on which his sales are to be financed, the retailer completes a proposal form giving particulars of each sale as it is completed. The finance company will require general

information as to the nature of each sale, showing whether the article sold is of a durable and marketable nature, fulfilling the requirements set out on page 10. Failure to insist on observance of the cardinal principles of sound hire-purchase trading might involve the finance company in serious losses through customers' default, and careful enquiries are necessary before accepting proposals if the business of the finance company is to be profitably conducted.

References are required from the customer, and when these have been found in order he is asked to sign a hire-purchase agreement with the finance company.

The company will then purchase the article from the retailer for cash at an agreed price, which may be either the ordinary cash price or something less, as will be explained later. **The arrangement, therefore, involves a cash sale by the trader to the company, and a sale on hire-purchase terms by the latter to the retailer's customer.**

The customer is liable direct to the finance company for payment of the instalments and for observance of the conditions of the agreement. In the event of a breach of any of the conditions, including non-payment of the instalments, the finance company may exercise any of a seller's rights, including that of repossessing the goods.

The retailer is normally relieved of further responsibility in the matter, the finance company collecting instalments as they become due and arranging for the article to be insured against loss. In passing, it might be noted that the placing of such insurances frequently forms a lucrative side line in finance company business.

Several variations in the details of the above procedure may be met with in practice. Some companies waive the necessity for customers' references; others affix identification marks to the goods to indicate their owner-

ship. The chief variations, however, are to be found in the relations existing between the retailer and the finance company.

The simplest arrangement is that already explained, whereby the finance company assumes full responsibility for collecting instalments. So far as the retailer is concerned, such transactions are cash sales to the finance company and he is under no liability if a customer defaults. When a customer exercises his option to return an article, there is no obligation on the part of the retailer to repurchase it from the finance company.

Other methods usually impose a liability on the retailer and the following may be instanced :—

- (a) The finance company may require the retailer to join as guarantor in the agreements with customers, in which case the retailer would be responsible for any loss suffered by the company in the event of a customer's default.
- (b) The finance company may require bills to be drawn on customers for the amount of each instalment and endorsed by the retailer. In the event of dishonour of a bill, the retailer would be liable to the finance company as endorser.
- (c) The finance company may require the retailer to enter into an agreement undertaking to repurchase any goods returned by customers or repossessed by the company when customers default, the price being fixed to equal the amount of the unpaid instalments, thereby relieving the finance company of loss on the transaction.

In essence the transactions remain cash sales from the retailer to the finance company, and it is important to remember this when considering the effect of these various methods in connection with his balance sheet. The instalments due from customers are not an asset of the

retailer and do not appear in his balance sheet ; when he is relieved of liability to the finance company, completed transactions need not affect his balance sheet any more than cash sales ; the price at which goods are sold to the finance company is received by him in cash as soon as the relative agreements are signed by customers, and consequently no question of apportioning profits over the length of agreements arises in the books of the retailer.

Guarantees of payment of instalments under methods (a) and (b) described above will, however, involve contingent liabilities which must be mentioned in the balance sheet. In addition, it is prudent to create a reserve to meet possible losses arising on uncompleted contracts, corresponding to the bad debts reserve which most traders consider it necessary to maintain.

By method (c), as will be readily appreciated, the ultimate effect is similar to that arising from method (a) where the retailer guarantees his customers. Instead of a contingent liability as usually understood, there is an undertaking to purchase goods in certain circumstances at prices which may be far in excess of their second-hand values. A suitable note explaining the circumstances should, therefore, appear in the balance sheet and a reserve for contingent losses should be created.

A case of considerable importance to finance companies recently came before the Court of King's Bench and set at rest any doubt which may have existed as to the legal effect of their method of business described above. The plaintiffs, a Finance Corporation, claimed for certain instalments due under a hire-purchase agreement relating to a motor lorry. The Finance Corporation had purchased the lorry for cash from the original owner and had resold it to the defendants under a hire-purchase agreement. There was an undertaking by the original owner similar to that described in method (c) on page 115 whereby he

would retake the lorry at a price to be fixed if the customer failed to pay the instalments. The defendants claimed that the Finance Corporation was an unregistered money-lender, or alternatively that the transaction was really an advance on the security of the motor lorry and that the requirements of the Bills of Sale Acts had not been complied with. Mr. Justice Acton held that on the facts the transaction was perfectly genuine and was what it purported to be, that is, the plaintiffs had purchased the lorry and were selling it to the defendants on the hire-purchase system. Neither the Bills of Sale Acts nor the Moneylenders Act therefore applied and judgment was entered for the Finance Corporation. He indicated, however, that if it had appeared that the hire-purchase agreement was merely a cloak to conceal a loan then the position might have been different. (*Automobile and General Finance Corporation, Ltd. v. Morris and Another* (*The Times*, 19th June 1929).) Each case depends on its merits but it is evident that transactions entered into in the ordinary course of business by finance companies cannot be upset on grounds such as were advanced in the above case.

It has been stated that the retailer sells the goods to the finance company at cash prices or something less, according to circumstances. The price which the finance company is prepared to pay will naturally be less than that at which it resells to the customer, and the margin demanded depends on several considerations.

In the first place the retailer receives immediate payment, whereas the finance company will receive payment by instalments spread over the period of the agreement. By purchasing the article from the retailer for cash and selling to the customer in consideration of future instalments, the finance company is, in effect, buying the right

to an annuity for a limited period, and therefore the purchase price should not exceed the present value of the annuity based on a commercial rate of interest.

A second factor is the cost involved in collecting instalments, for which purpose an office organisation will need to be maintained. As the retailer is relieved of this overhead charge, he is able to effect a corresponding reduction in price to the finance company.

Thirdly, there is the risk of incurring bad debts which will be greater when the company bears the whole risk than when the trader guarantees payment of instalments, but it must not be assumed that in the latter event the finance company runs no risk whatever. Instances have occurred of a retailer becoming insolvent and ceasing business, with the result that the finance company has not only been deprived of the guarantee but has also had to undertake the retailer's obligations to the customers, arising, for example, from offers of free maintenance during the currency of agreements. An experience of this nature is referred to on page 166. The margin allowed for bad debts in fixing the price may be regarded as an insurance premium paid by the retailer, since it assists in spreading risks over the whole of the business which is financed. In this way, contracts which are not intrinsically unsound, yet which involve more than the average risk, can sometimes be financed on the usual terms.

A fourth factor is the profit to the finance company.

The difference between the amount paid to the retailer and the price to the customer is therefore made up of interest on the deferred instalments payable by the customer, administrative expenses, provision for bad debts and profit to the finance company.

There are two methods of fixing the price to the customer. Either the trader is paid the cash price of the article to which is added the margin for expenses and

profit, the whole being charged to the customer ; or the retail price may be paid by the customer, the trader bearing the charge for expenses and profit. The effect of these methods may be illustrated by the following examples of terms quoted by two finance companies.

A company financing sales of motor-cars, in circumstances which relieve the retailer of responsibility for bad debts and collection of instalments, quotes the following terms: On a car costing £400, a deposit of £100 is required, the balance being payable by 12 monthly instalments of £26 12s. 6d. The charge for hire-purchase facilities is therefore £19 10s., equivalent to an approximate rate of 12 per cent. per annum on the amount outstanding from time to time, and is payable by the customer.

A company financing sales of a miscellaneous character pays the price of the goods to the trader less a discount which varies from $17\frac{1}{2}$ per cent. to 25 per cent. The price is charged to the customer who is not asked to pay directly for finance facilities. Probably the risks attaching to this business would be heavier than in the case of the first company, and allowance should accordingly be made when comparing their terms.

Certain large groups of associated companies engaged in retail trading have formed their own private finance companies through which they obtain accommodation from bankers. Goods sold to customers are purchased by the finance company from the associated companies for cash and sold by the former to the customers on hire-purchase agreements which are in the name of the finance company. The finance company then raises bank loans on the security of the agreements and thus obtains funds which enable it to pay the associated companies for the goods. The whole of the agreements are thus available to the bank as security, irrespective of which company has made the sale. As the finance company is merely

an intermediary, no question of profit need arise, all working expenses and bad debts usually being borne directly or indirectly by the associated companies (a).

The formation of a private finance company is, in effect, merely another method of raising bank loans, and must be clearly distinguished from financial arrangements made through an independent company whose organisation is available to any approved trader. While the existence of a private company may not appear at first sight to be of much advantage, a bank may be more ready to grant loans to such a company against hire-purchase sales than to a trader whose instalments are mixed with his general business.

Comparison of the Three Methods

The three methods of financing hire-purchase operations dealt with in the foregoing pages give rise to special problems which deserve careful consideration before deciding which is best suited to the needs of a particular business, and their relative advantages may be usefully compared.

The first method was that of drawing bills and discounting them at a bank. From what has been written, it will be apparent that this procedure is not particularly adaptable to businesses where the sales are numerous and involve amounts ranging from a few pounds upwards. In practice, the method is a ready means of furnishing accommodation for large contracts and has the advantage that the amount of bills discounted can easily be regulated to the financial requirements of the business. No complicated legal agreements need be completed since the method is simple and merely an application of a well-understood and old-established practice to meet modern

(a) For an example of the necessary bookkeeping entries, see Chapter VI.

needs. It is much favoured by dealers in motor-cars, but is practically unknown among retailers of furniture and household articles.

Two courses remain open to the general trader: to have recourse to a bank or to a finance company; which of the two is preferable must remain a matter of individual opinion.

It is probable that the interest payable to a bank will be much less than the charge made by a finance company, but by availing himself of the facilities offered by the latter, the trader has the advantage of the organisation maintained by the company for enquiring into the financial position of prospective customers. The company assumes responsibility for declining unsatisfactory customers, and thus the trader often avoids unpleasantness and possible disturbance of his trade. On the other hand, customers may object to signing agreements with a finance company which they do not know, and may feel that the element of secrecy is lacking. Despite the broadening of public opinion, secrecy is still a factor in the success of hire-purchase schemes.

By arranging his hire-purchase business through a finance company, the trader is relieved of the necessity for collecting the periodical instalments, and is thus able to avoid the incidental overhead expenses. When preparing a balance sheet and trading account, he is able to treat the hire-purchase transactions as cash sales, thus avoiding any question of apportioning profits by one of the methods explained in Chapter IV. Small traders in particular find this simplification of the accountancy records advantageous.

There may be a feeling on the part of the trader that by assigning customers to a finance company he loses touch with them, and is powerless to exercise leniency in cases where instalments have fallen into arrear through

temporary adverse circumstances. On the other hand it is not to the benefit of finance companies to acquire a reputation for harsh dealings. Their interests and those of the trader are closely related. At the same time, it does not always follow that leniency is desirable, and it may be better, both for the trader and his customers, when the collection of instalments is in the hands of a third party.

To these and other points careful consideration should be given and a final choice of the method of raising capital can be made so as to suit the requirements of each individual business.

CHAPTER VI

BOOKKEEPING SYSTEM (continued)

APPORTIONMENT OF INTEREST ON SALES.

APPORTIONMENT OF PROFIT ACCORDING TO INSTALMENTS
RECEIVED.

STOCK SYSTEM.

WEEKLY PAYMENTS.

PRIVATE FINANCE COMPANIES.

VI.—BOOKKEEPING SYSTEM

(continued)

THERE was described in Chapter III a system of book-keeping suitable for a hire-purchase trader, and although the broad principles employed are applicable to all businesses of that type, it may be found in practice that slight variations in detailed procedure are necessary to meet individual peculiarities. While such modifications should not present any difficulty, the adaptation of the system required by alternative methods of dealing with the trading profits, such as were described in Chapter IV, calls for explanation. Special entries may also be necessary in connection with arrangements for financing the instalment business.

Apportionment of Interest on Sales

In Chapter III it was assumed that the trader marked his goods for sale at hire-purchase prices, but such is by no means a general custom; when he quotes cash prices, adding interest for hire-purchase sales, his records must provide a means whereby the interest which is charged can be segregated in the books and credited to the profit and loss account in proportion to the instalments falling due month by month. For this purpose it is necessary to look at the hire-purchase agreements, which contain a schedule of the goods sold and the interest which is added to the prices. For example :—

THE SCHEDULE HEREINBEFORE REFERRED TO			
<i>One Oak Dining-room Suite</i>	..	£20	0 0
<i>3% Interest for 20 months</i> ..	..	I	0 0
		<hr/>	
		£21 0 0	
		<hr/>	

The first step in the system which needs modification is, therefore, the advice of sale to the bookkeeping department (Example 3). The advice must show not only the amount of the sale but also the interest, and a carbon copy of the Schedule to the Agreement should therefore be made on the back of the advice.

The analysis of sales which is prepared by the dissection office from the advices should distinguish between the total of the cash sale prices and the interest. Thus :—

Period of Agreements	Cash Sale Price	Interest	Total	Initial Paym'ts	Mthly Instalments
6 months ..	£ 1,500	£ 66	£ 1,566	£ 311	£ 251
9 „ ..	900	54	954	106	106
12 „ ..	2,300	148	2,448	248	200
20 „ ..	20	1	21	2	1
24 „ ..	3,200	424	3,624	151	151
	£7,920	£693	£8,613		

No distinction need be made on customers' ledger accounts between the cash sale price and the amount added for interest ; the whole may be debited in one sum. Similarly no alteration is required in the Running Summary of Instalments falling due, as it is of no consequence what portion of an instalment represents interest. All necessary apportionments of interest can be made in total by keeping a summary in the form shown in Example 15 on the opposite page. Preparation of the summary follows very closely on that of the Running Summary of Instalments falling due. It will be seen from the example that a rateable proportion of the interest on each class of agreements is credited to each half-year during which the relative agreements will be current, due allowance being made for broken periods.

When quarterly profit and loss accounts are prepared,

INTEREST SUMMARY

Date	Period of Agreement	Total	Half-year ended							
			31/12/28	30/6/29	31/12/29	30/6/30	31/12/30	30/6/31	31/12/31	
1928		£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	£ s d	
Sept. 30	Forw'd	3,128 0 0	865 0 0	742 0 0	538 0 0	399 0 0	328 0 0	256 0 0		
	6 mths.	66 0 0	33 0 0	33 0 0						
	9 "	54 0 0	18 0 0	36 0 0						
	12 "	148 0 0	37 0 0	74 0 0	37 0 0					
	20 "	1 0 0	3 0 0	6 0 0	6 0 0	5 0 0				
	24 "	424 0 0	53 0 0	106 0 0	106 0 0	106 0 0	53 0 0			

EXAMPLE 15

four columns to each year are necessary in the interest summary, but when accounts are only drawn up annually, one column for each year is sufficient. This method is much simpler than entering the agreements in an analysis book and apportioning the interest on each sale separately, while the results obtained are sufficiently accurate for ordinary purposes. Rebates of interest allowed to customers on prepayment of instalments should be credited in the summary to the future periods concerned and adjustments should also be made when debts are written off as bad.

A suspense account should be opened in the private ledger and credited monthly with the interest charged to customers. The journal entry for the monthly sales will therefore be :—

	£	£
Sundry Debtors for Instalments under Hire-Purchase Agreements	8,613	
To Hire-Purchase Sales		7,920
" " Interest Suspense		693

When a profit and loss account is prepared for any period, the appropriate column of the interest summary is totalled and ruled off, and a transfer made from the suspense account to the credit of profit and loss account for the interest which has accrued during the period. The balance on the suspense account, representing interest which has not accrued, should be deducted from the total debts due from customers which appear in the balance sheet and should agree with the total of the relative columns of the summary.

In small offices where a sales day book is kept, additional columns should be provided in the day book for "Cash Price" and "Interest" (Example 16). If separate sheets are used to record agreements which extend over different periods, the monthly totals will then furnish a ready means of obtaining the figures for the interest

SALES DAY BOOK

(20 Instalments)

Date	Name	Address	Fo.	Total Debit	Cash Price	Interest	Initial Payment	Monthly Instal- ments
1928 Sept. 5	John Smith ..	999 Black St., N.		£ s d 21 0 0	£ s d 20 0 0	£ s d 1 0 0	£ s d 2 0 0	£ s d 1 0 0

EXAMPLE 16

summary and for the Running Summary of Instalments falling due.

It will be observed that interest is spread rateably over the period of agreements, whereas the number of instalments outstanding steadily decreases, and this leads to the existence of a secret reserve, the aggregate amount of which is not readily ascertainable although it is not difficult to compute on individual agreements. The accurate calculation of interest on the outstanding balance of a debt was shown on page 14, and applying the principle to a sale of £100 payable by 36 monthly instalments with interest for three years at $2\frac{1}{2}$ per cent. per annum on the cash price, the correct allocation of the interest will be found to be :—

First year	..	..	..	..	£4	2	0
Second year	..	..	..	..	2	10	0
Third year	..	..	..	..	0	18	0
					<u>£7</u>	<u>10</u>	<u>0</u>

In the interest summary, spreading the interest rateably over the period, each year would be credited with £2 10s., and the effect is therefore to under-credit the first year by £1 12s., and to over-credit the third year by a like amount. There is thus an excess interest reserve of £1 12s. carried forward at the end of the first and second years.

Assuming that payments are regularly made when due, the instalments outstanding will amount to :—

£71 13s. 4d. at the end of the first year, and

£35 16s. 8d. at the end of the second year,

and the excess interest reserve will be equivalent to 2.23 per cent. and 4.46 per cent. of these amounts. As the customers' accounts will be in various stages of liquidation, neither of these percentages nor their mean can be applied to the total debts outstanding to calculate the secret reserve, but its existence is obvious, and by taking

several representative agreements the amount of the reserve can be approximately estimated.

Apportionment of Profit according to Instalments Received

It was mentioned in Chapter IV that the profit on hire-purchase sales may be spread over the length of agreements either according to instalments falling due or according to instalments received as may be desired, and the method which was followed in Chapter III for carrying out the first alternative can be readily adapted to the second.

In all but the smallest businesses it would be impossible to compute the profit separately on each agreement and if it is desired to have regard to the varying rates of profit earned each year while at the same time making the apportionment in bulk on the total instalments received, the first step is to credit the total trading profit of each period to a suspense account as was done in Chapter III.

All cash received in respect of instalments must then be analysed according to the years in which the relative sales were effected. The method which is recommended is to prefix the serial number of each agreement with a letter to denote the year to which it relates. The serial letter and number should appear at the head of each customer's account and when the ledger clerks are posting cash received to the ledger from the carbon copies of the receipts, they should mark the serial letter prominently on each carbon copy. There is then no difficulty in preparing an analysis of the cash arranged according to the years in which the relative sales were made. The rate of gross profit which was earned in each year will be known, and by calculating the appropriate percentages on the instalments received, the amounts to be transferred from the suspense account to profit and loss account can be

ascertained. Care should be taken when writing off bad debts to make a corresponding transfer of the profit which is held in suspense, as it will be apparent that the required adjustment can no longer be made through the Running Summary of Instalments which, under this method, is not brought into use in apportioning profits.

An alternative is to analyse all debts due from customers at the date of the balance sheet according to the years in which sales were made, and to carry down on the suspense account a sum equivalent to the appropriate percentages on the various debts, the balance of the suspense account being then transferred to profit and loss account. This analysis would have to form a special operation at a time when the books were being balanced for the annual accounts, and is consequently less satisfactory than the first suggestion. It should also be observed that when the cash received is analysed as part of the normal routine, the profit to be transferred from the suspense account can be ascertained monthly or at any other desired interval, thereby facilitating prompt preparation of interim trading accounts.

When the ratio of profit to turnover does not show any great variation from one year to another, an approximate apportionment can be obtained by carrying forward in suspense an amount of profit equal to a fixed percentage of all unpaid instalments, thereby avoiding an analysis of either the cash received or the balances on customers' accounts. No adjustment is necessary for bad debts written off, because they will have operated to reduce the outstanding instalments on which the percentage is calculated. When the ratio of profit is subject to great variation, however, the effect would be that in respect of instalments not due at the end of a year and still unpaid at the end of the following year, profit would be carried

forward at different rates and the preparation of accurate accounts would be impossible.

Stock System

A system of keeping hire-purchase accounts which is sometimes met with is known as the "Stock System." A memorandum ledger is kept in which an account for each customer is opened. Full particulars of the hire-purchase agreements, including the due dates and amounts of instalments, are entered at the head of the ledger accounts, as well as the cost prices of the goods sold. The cost prices are also entered in a day book and the total is transferred periodically from the credit of stock account to the debit of goods on hire-purchase account. This entry is merely a transfer of stock at cost price and transactions are not treated as sales at this stage. All cash received for instalments is posted in detail to customers' accounts in the memorandum ledger and also in total to the credit of goods on hire-purchase account.

When a balance sheet is prepared, the proportion of the cost price of all goods in the hands of customers relative to the instalments which have not fallen due for payment is extracted from the memorandum ledger. Thus, assuming an article costing £60 is sold for £96, payable by equal instalments spread over three years, and six instalments have fallen due, the portion of the cost price to be extracted would be £50. This sum is treated as the value of stock in the hands of customers at the date of the balance sheet and is carried down as a debit balance on the goods on hire-purchase account. The balance of the cost price—£10—when deducted from the instalments which have been received—£16—gives the gross profit for the period, in this case, £6. Any instalments in arrear at the date of the balance sheet are treated as debts.

The goods on hire-purchase account might be as follows:

£		£
To Goods in hands of customers 1st Jan. 1929, at cost	1,000	By Cash received for Instalments :— 1928 Contr'ts £750 1929 1,350
„ Cost of Goods delivered to customers during the period	4,000	
„ Gross Profit	750	2,100
		„ Instalments due and unpaid
		150
		„ Value of Goods in hands of customers 30th June 1929, at cost
		3,500
	<u>£5,750</u>	<u>£5,750</u>
To Balance brought down— Goods in customers' hands, at cost	3,500	
„ Unpaid Instalments	150	

The calculation of the value of goods in the hands of customers at 30th June 1929 would, in practice, be done in detail, but can be summarised as follows :—

	Cost Price	Sale Price	Value of Stk. at cost
Goods on hand 1st January 1929	£ 1,000	£ 1,500	£
Instalments received		750	
Proportion of cost price relative to instalments unpaid 750/1,500 of £1,000 ..			500
Goods delivered during period	4,000	6,000	
Instalments received		1,350	
Instalments due and unpaid		150	
Proportion of cost price relative to instalments unpaid (excluding those due for payment) 4,500/6,000 of £4,000 ..			3,000
Total value of Goods in hands of customers, at cost			<u>£3,500</u>

It will be seen that the gross profit on transactions is spread rateably over the period of agreements so that the

effect is the same as that reached with the aid of the Running Summary of Instalments as explained in Chapter III. The advantages claimed for the system by certain writers are that it more correctly records the true nature of hire-purchase sales, since customers are not treated as debtors for instalments which have not fallen due. It has already been seen, however, that for bookkeeping purposes the legal and accountancy conceptions of hire-purchase transactions are difficult to reconcile and that as a matter of expediency the accountancy aspect must prevail. Quite apart from the initial difficulty of ascertaining the cost price of goods sold, there is serious objection to the stock system on account of the labour involved, as would be speedily realised by anyone attempting to extract the unpaid portion of the cost prices of goods in the hands of customers of a retailer having a large turnover made up of a multitude of small sales. The system would be practicable for a business having a limited number of sales of substantial amounts, as, for example, a manufacturer of costly machines, but besides these difficulties there are other objections to the stock system arising from the form in which trading accounts have to be prepared.

The accounts afford no indication of the annual turnover, but merely show cash received for instalments. Hence there is no standard with which to compare selling expenses; when a trading account is prepared in the normal way to show the gross turnover, expenses can be expressed as a percentage of sales, and variations from one year to another become apparent. It will be obvious, however, that selling expenses bear no relation to cash received.

The stock system also obscures the position with regard to bad debts, which are usually dealt with by transferring the unpaid portion of the cost price of goods, after

allowance for any sums realised by repossessions, from goods on hire-purchase account to bad debts account. The effect is then to show losses at a much lower figure than would be done had transactions been treated as sales, when the unpaid portion of the selling value of goods would have been debited. If no transfer is made to bad debts account, amounts realised from the sale of repossessed goods being merely included with instalments received, losses are merged with the gross profit and no information whatever is given as to their amount.

A trading account which is based on the stock system does not show the gross profit for the year, but only part of the profit on a number of transactions which have been effected during perhaps the previous three or four years. Hence a useful check on the accuracy of the stock on hand is lost, and all the usual information which business men are accustomed to expect from their accounts is lacking. By carrying out the system explained in Chapter III, profits can be apportioned with the same effect as is secured by the stock system, while at the same time the trading and profit and loss accounts can be prepared in their normal form.

Weekly Payments

It has been assumed in this book that instalments under hire-purchase agreements would be payable at monthly intervals, but the principles which have been enunciated are equally applicable to businesses where weekly payments are the rule.

The only important modification which requires notice arises in connection with the bookkeeping system. The number of instalments payable by customers would be increased fourfold, adding considerably to the work of the cashier and making the slip system almost

indispensable in his department. No deviation from the system of bookkeeping outlined in Chapter III is necessary, however, except in regard to preparation of the Running Summary of Instalments falling due. The purpose of the summary is to furnish information as to the instalments falling due, with a view to assisting in compiling financial budgets, keeping a check on instalments in arrear, and facilitating accurate apportionment of trading profits over the length of agreements. Although weekly payments may be in force, monthly columns can be retained in the summary, without detracting from its practical utility, by dividing the total amount payable under each class of agreement into equal monthly parts. When desired, this operation may be carried out weekly and allowance made for broken periods. The summary will then provide sufficiently accurate data, for although the amount falling due in a month may be slightly understated in respect of particular agreements when five weekly payments accrue, the effect will be mitigated by the averaging of other agreements where only four instalments are due, and the transitory inaccuracy would be of no importance. The Summary should be totalled at the end of each month because a month is a convenient period for which to prepare statistics and that usually adopted for balancing the financial books.

Private Finance Companies

When a trader, or group of associated trading companies, has formed a private finance company to act as intermediary for obtaining bank loans, the skilled accountant will find scope for devising suitable means of recording sales with a minimum of labour. The usual form of legal agreement governing the relations of trader, private finance company, and bank, is such that

to keep a complete record of transactions in the books of both trader and finance company would involve duplication of entries, and before attempting an explanation of how the work can be materially reduced, the effect of the tripartite arrangement must be examined.

The private finance company undertakes to supply goods on hire-purchase terms to customers of the trader, purchasing the goods from the trader and supplying them to customers at prices equivalent to those which customers would have paid had they been supplied on hire-purchase terms direct by the trader, so that the profit of the latter is not affected. A fixed percentage of the price—say 75 per cent.—is payable by the finance company to the trader on the date of sale, and the balance—in this instance 25 per cent.—only on the happening of certain events which will shortly appear.

The hire-purchase agreements are between customers and the finance company, to which instalments are legally payable. When an agreement is signed by a customer, the company applies to the bank for a loan of 75 per cent. of the amount of the sale and deposits the hire-purchase agreement as security. The company is thus placed in a position to discharge its liability to the trader in respect of 75 per cent. of the sale price of the goods which is payable on the date of sale.

The trader is appointed agent of the finance company for the purpose of collecting instalments as they become due from customers, and all sums so collected are paid over to the finance company and thence to the bank in reduction of its loan. When the amount collected in respect of an agreement aggregates 75 per cent. of the instalments, at which point the amount advanced by the bank in respect of that agreement will have been paid off, further instalments as received are to be applied first in satisfaction of amounts advanced against other agree-

ments where instalments are in arrear, and the balance (if any) is to be repaid by the finance company to the trader in satisfaction of the 25 per cent. unpaid portion of the sale price of the goods. It will thus be seen that, although in the first instance loans are obtained against individual agreements, the 25 per cent. margin is available as cover for the whole of the advances. The tripartite arrangement further provides that, if the whole of the instalments are not collected, the finance company's liability to the trader is to be correspondingly reduced, so that, in effect, although instalments are assets of the finance company, responsibility for bad debts rests with the trader.

The foregoing arrangement may seem somewhat involved, but the ultimate result is that the trader receives immediate payment for 75 per cent. of the sale price of goods purchased by customers, and the balance of 25 per cent. as and when the last instalments are paid : the finance company is purely an intermediary and all cash received is at once paid away ; it makes no profit on sales, but may charge the trader a service fee or commission to cover expenses and bank interest : the bank advances 75 per cent. of the value of sales, and is repaid out of the first instalments received from customers, meanwhile holding the hire-purchase agreements as security.

In order to make the position clearer, two sales may be taken as an example :—

Customer A. purchases goods to the value of £60 payable by 12 monthly instalments of £5.

Customer B. purchases goods to the value of £40, payable by 10 monthly instalments of £4.

When the agreements have been completed, the bank

loan obtained, and the first instalments paid, the position will be :—

The trader has sold goods to the finance company for £100 and has received 75 per cent. of the sale price, i.e. £75, and has a debt of £25 due from the finance company.

The finance company has purchased goods from the trader for £100 and has resold them to customers at the same price ; it has received £75 on loan from the bank, which it has paid to the trader, and has received the first instalments from the trader, i.e. £9, which it has paid to the bank. There are thus instalments due from customers £91, and liabilities to the bank £66, and to the trader £25.

The bank has advanced to the finance company £45 in respect of the sale to customer A. and £30 in respect of the sale to customer B.—a total of £75—on the security of hire-purchase agreements for £100 and has been repaid £9.

Proceeding now to the stage when each customer has paid three further instalments on the due dates :—

The trader's position remains unchanged.

The finance company has received from the trader, acting as its agent for the collection of instalments, £27, representing three monthly instalments of £5 and £4 respectively, which it has paid to the bank in reduction of the loan account. It has as an asset £64 due from customers, and liabilities of £39 to the bank and £25 to the trader.

The bank has a loan of £39 to the finance company on the security of unpaid instalments amounting to £64.

When seven instalments have been paid on the due dates and have been passed to the bank in reduction of the loan, there will remain only £2 outstanding of the amount advanced in respect of agreement B. When, therefore, the eighth instalment of £4 is received it is only necessary to pay to the bank £2, and the remaining

£2 is repaid to the trader. The position after the eighth instalment has been paid is therefore :—

The trader has a debt of £23 due from the finance company.

The finance company has an asset of £28 due from customers, and liabilities of £5 to the bank in respect of agreement A. and £23 to the trader.

The bank has a loan of £5 to the finance company against the security of unpaid instalments on agreement A. of £20, and on agreement B. of £8, the latter amount being available only in the event of customer A. falling into arrear.

The foregoing instances are representative of the various stages through which the transactions pass, and an endeavour will now be made to show a comparatively simple method of keeping the books of account, though it will be realised that operations of such a nature cannot be unduly compressed without risk of leading to confusion.

Dealing first with the trader's books, it is desirable that he should keep the customers' accounts in his own ledgers as he is responsible for collection of instalments, although the debts are due to the finance company. This applies with additional force when there are several associated trading businesses working through the same finance company, as the accounts related to each business can be kept locally. A section of the Customers Ledger should, therefore, be allotted to sales passed through the finance company, and a separate control or total account opened in the private ledger. As the prices charged to customers are the same as those charged to the finance company, sales may be treated in the same way as if they were direct sales between trader and customers, and the total sales debited to the control account may be regarded as a debit to the finance company. To this extent the account serves both as a control over entries in the Customers Ledger and as a personal account with the

finance company. For the purpose of the trader's balance sheet, the section of the Customers Ledger is treated as a memorandum record, and the control account is regarded as showing the state of affairs with the finance company.

Cash received by the trader from the finance company on account of the price of sales is credited to a separate account which may be designated "Finance Company No. 2 Account." The difference between amounts debited to the control account and credited to No. 2 Account then represents the balance owing to the trader from the finance company.

When instalments are received from customers, the cash is credited to the control account, and at the same time a corresponding payment is made by the trader to the finance company which is debited to the No. 2 Account. The difference between the balances on the two accounts therefore remains unaffected.

When the stage is reached where the finance company commences to pay off the outstanding 25 per cent. of the sale price of goods, amounts received are credited to the No. 2 Account, and the difference between the balances on the two accounts continues to represent the amount due from the finance company.

Needless to say, when preparing the trader's balance sheet, the balances on the two accounts are amalgamated to show only the net position.

Since the finance company is merely a subsidiary of the trader who keeps a complete record in his books of the state of each customer's account, there is no need for this information to be duplicated in the books of the finance company. No difficulty is likely to result by reason of the finance company having no detailed record of its book debts, but, if thought necessary, a clause can be inserted in the tripartite agreement, whereby customers' accounts

are to be open to inspection by the finance company at any time. Entries in the books of the finance company can then be confined entirely to totals, sales being debited at convenient intervals to a total debtors' account and credited to the trader's account; instalments are paid over by the trader in bulk and are credited to the total debtors' account; other cash receipts and payments are posted in the usual way to the appropriate accounts.

In order to simplify the preceding remarks, it has been assumed that instalments are paid by customers as they fall due, but it will frequently happen that this is not the case. If the arrangement between the trader, private finance company, and bank were strictly followed in respect of each separate sale, it will be evident that a considerable amount of detailed work would be involved in keeping account of the date when payments to the bank by the finance company ceased in respect of each sale and payment to the trader commenced in respect of the unpaid 25 per cent. of the sale value, but all the essential elements of the scheme are preserved by adopting the following method, without in any way prejudicing the rights of the parties under the tripartite agreement.

A list of sales together with the relative hire-purchase agreements is delivered to the bank each month showing the total value of sales for each different period of credit, and a loan is obtained for an amount equal to 75 per cent. of the total value of the sales; this loan enables the finance company to discharge that part of its liability to the trader which is immediately payable. A separate Running Summary of Instalments falling due is kept by the trader for sales passing through the finance company, and he pays to the company at the end of each succeeding month a sum equal to the instalments falling due during that month, whether received from customers or not.

Overdue instalments will therefore now be assets of the trader, as distinct from instalments not due which are assets of the finance company.

If the Customers Ledger Control Account (Finance Company Sales) is subdivided into two parts—one for instalments not due, and the other for instalments due—as was done in Chapter III—the balance on the latter section will represent debts due to the trader from customers while the difference between the balances on the former account and the Finance Company No. 2 Account will represent the amount due from the finance company.

It will be seen that complications with unpaid instalments are now avoided, and, save in exceptional circumstances, no question arises of applying instalments from one agreement against a loan on another. By suitably modifying the Running Summary of Instalments falling due, the amounts to be paid to the bank and repaid to the trader by the finance company can be shown. When entering in the summary the future instalments receivable in respect of each group of agreements, the amounts should be entered in black ink until they total 75 per cent. of the value of the sales and the remaining 25 per cent. should be entered in green ink. The two sets of figures should be totalled separately, so that each month the instalments falling due will comprise two amounts, that in black ink representing the amount due to the bank, and that in green ink the amount due to the trader. Arranged in this form, the summary not only serves the purposes of the trader, but also gives information required for the books of the finance company. With the aid of the foregoing explanations, the entries on the following *pro forma* accounts should present little difficulty.

TRADER'S BOOKS

CUSTOMER "A"

1928		£ s d	1928		£ s d
July 10	To Goods	60 0 0	July 10	By Cash ..	5 0 0
			" 10	" " "	10 0 0
			Oct. 10	" " "	5 0 0
			Nov. 10	" " "	5 0 0
			Dec. 10	" " "	5 0 0
			1929		
			Jan. 10	" " "	5 0 0
			Feb. 12	" " "	5 0 0
			Mar. 12	" " "	5 0 0
			Apl. 10	" " "	5 0 0
			May 10	" " "	5 0 0
			Jun. 10	" " "	5 0 0
		<u>£60 0 0</u>			<u>£60 0 0</u>

CUSTOMER "B"

1928		£ s d	1928		£ s d
July 16	To Goods	40 0 0	July 16	By Cash ..	4 0 0
			Aug. 16	" " "	4 0 0
			Sep. 17	" " "	4 0 0
			Oct. 16	" " "	4 0 0
			Nov. 16	" " "	4 0 0
			Dec. 17	" " "	4 0 0
			1929		
			Jan. 16	" " "	4 0 0
			Feb. 16	" " "	4 0 0
			Mar. 16	" " "	4 0 0
			Apl. 16	" " "	4 0 0
		<u>£40 0 0</u>			<u>£40 0 0</u>

SUNDRY DEBTORS FOR INSTALMENTS DUE

1928	To Instalments due	£	s	d	By Cash	1928	£	s	d
July 31	..	9	0	0	..	July 31	9	0	0
Aug. 31	..	9	0	0	..	Aug. 31	4	0	0
Sept. 30	" "	9	0	0	..	Sept. 30	14	0	0
Oct. 31	" "	9	0	0	..	Oct. 31	9	0	0
Nov. 30	" "	9	0	0	..	Nov. 30	9	0	0
Dec. 31	" "	9	0	0	..	Dec. 31	9	0	0
1929						1929			
Jan. 31	" "	9	0	0	..	Jan. 31	9	0	0
Feb. 28	" "	9	0	0	..	Feb. 28	9	0	0
Mar. 31	" "	9	0	0	..	Mar. 31	9	0	0
April 30	" "	9	0	0	..	April 30	9	0	0
May 31	" "	5	0	0	..	May 31	5	0	0
June 30	" "	5	0	0	..	June 30	5	0	0
		£100	0	0			£100	0	0

PRIVATE FINANCE COMPANY'S BOOKS

SUNDRY DEBTORS FOR INSTALMENTS UNDER HIRE- PURCHASE AGREEMENTS

1928		£ s d	1928		£ s d
July 31	To Sales	100 0 0	July 31	By Cash per Trader	9 0 0
			Aug. 31	" "	9 0 0
			Sep. 30	" "	9 0 0
			Oct. 31	" "	9 0 0
			Nov. 30	" "	9 0 0
			Dec. 31	" "	9 0 0
			1929		
			Jan. 31	" "	9 0 0
			Feb. 28	" "	9 0 0
			Mar. 31	" "	9 0 0
			Apl. 30	" "	9 0 0
			May 31	" "	5 0 0
			Jun. 30	" "	5 0 0
		£100 0 0			£100 0 0

LOAN FROM BANKERS

1928		£ s d	1928		£ s d
July 31	To Cash— part re- payment		July 31	By Cash ..	75 0 0
Aug. 31	" "	9 0 0			
Sep. 30	" "	9 0 0			
Oct. 31	" "	9 0 0			
Nov. 30	" "	9 0 0			
Dec. 31	" "	9 0 0			
1929					
Jan. 31	" "	9 0 0			
Feb. 28	" "	7 0 0			
Mar. 31	" "	5 0 0			
		£75 0 0			£75 0 0

TRADER'S ACCOUNT

1928 July 31	To	Cash on Account	..	£	s	d	1928 July 31	By Goods	£	s	d	
				75	0	0			100	0	0	Balance 31-12-28 £25 Cr.
												Balance 28-2-29 £23 Cr.
				2	0	0						
1929 Feb. 28	"	"	..	4	0	0						
Mar. 31	"	"	..	9	0	0						
April 30	"	"	..	5	0	0						
May 31	"	"	..	5	0	0						
June 30	"	"	..									
				£100	0	0			£100	0	0	

Entries on the accounts have been confined to the sales to customers A. and B., but it will be understood that further sales would normally appear each month, and reconciliation of the balances on the various accounts in the books of the trader with those of the finance company and with the Running Summary of Instalments is not affected. When several associated trading companies operate through the same private finance company, the latter will require to keep a separate account with each as well as separate total debtors' accounts, but in all other respects the procedure will follow that outlined on the preceding pages.

Turning now to the point of view of the bank, which will not only require to be satisfied that advances are adequately covered by instalments due from customers, but will also wish to keep the loan account in such a manner as to readily show this, an instance has come before the writer's notice where a separate loan account is kept for each monthly advance on each class of agreement. That is to say, if a trader sells goods on 6, 12, 18, 24 and 36 months' credit, there are five loan accounts each month. It is then necessary for the trader to submit statements showing the composition of amounts repaid to the bank in reduction of loans, which are merely copies of the items in the Running Summary of Instalments making up amounts paid to the bank. The latter is then able to allocate the monthly repayments to the appropriate loan accounts and to show the eventual settlement of the various loans within the period of the hire-purchase agreements. It is true that when instalments are paid to the bank irrespective of their receipt by the trader, repayment of the loans within that time follows as a matter of course, but it is more satisfactory to the bank when its books show the repayment instead of merely a running loan account.

In the absence of bills of exchange accepted by customers for the amount of each instalment and lodged with the bank as collateral security for advances, an arrangement such as the foregoing appears to be the next best method of ensuring that advances are adequately covered by current instalments.

CHAPTER VII

BAD AND DOUBTFUL DEBTS

RATIO OF BAD DEBTS TO TURNOVER OF VARIOUS COMPANIES.

PREPARATION OF STATISTICS BEARING ON BAD DEBTS.

METHOD OF DETERMINING LOSS ARISING FROM BAD DEBTS.

DOUBTFUL DEBTS RESERVE—METHOD OF EXTRACTING LISTS OF OVERDUE DEBTS AND CALCULATING RESERVE.

WHEN PROFITS ARE APPORTIONED—ADJUSTMENT FOR DOUBTFUL DEBTS RESERVE.

CREATION OF DOUBTFUL DEBTS RESERVE BY MEANS OF A CREDIT INSURANCE FUND.

FREE INSURANCE COVER—FIRE INSURANCE—LIFE INSURANCE.

VII.—BAD AND DOUBTFUL DEBTS

Ratio of Bad Debts to Turnover of Various Companies

A RELIABLE judgment of the financial position of a business can rarely be formed solely by reference to balance sheets. Many influences have to be considered, some of which by their nature cannot be fully revealed in the accounts, and when drawing conclusions from facts disclosed it must be remembered that the conditions under which most balance sheets have to be prepared make it inevitable that they should to some extent be founded on personal opinion. Even when they have been audited, the auditor's report is but an expression of opinion by a person whose training makes him peculiarly fitted for the work.

Consider, for example, the stock-in-trade, usually valued at cost or market price, whichever is lower. In every business it is essentially a matter of opinion whether, having regard to the marketable condition of the stock, such a basis of valuation is correct. Another example is the depreciation of fixed assets. For instance, machinery is frequently written down by 10 per cent. per annum, and although this and other commonly accepted rates have become almost standardised through long usage, they have been the subject of discussion from time to time, and many of them have no great merit.

As it is very unusual to disclose on the face of a balance sheet all the circumstances which have been taken into account in its preparation, it will be apparent that for anyone seeking detailed information the limited facts made available generally do little more than pave the way for a searching questionnaire on the various items.

The nature of the additional information required depends upon the purpose for which the balance sheet is being examined. If it is with a view to acquiring an interest in the business, particular attention will be paid to the earning power, and questions will be directed to ascertain whether the profits are correctly stated. If the object in view is to advance money on the security of the assets, then their value, particularly on a forced sale, will be of major importance. An intimate knowledge of the practical side of the business is invaluable, as it enables questions to be included on points which are not apparent from the accounts, but which have nevertheless contributed to bring about the state of affairs disclosed.

In the case of a hire-purchase business, attention can profitably be given to the amount included in the balance sheet for instalments due from customers, and it is of paramount importance to ascertain precisely how the instalments have been dealt with in the accounts. Various methods of treatment and their effect upon the profits were explained in Chapter IV, and it is unnecessary to elaborate them.

Careful enquiry should also be directed to finding out whether adequate reserves exist against bad debts and it must be remembered that hire-purchase debts differ widely from ordinary short-credit accounts. By the terms of the agreements, traders are entitled to recover goods in respect of which instalments are in arrear. On the other hand the goods, particularly when not of a durable nature, may in practice be found on recovery to have depreciated to such an extent that their realisable value is insufficient to cover the unpaid instalments. Although the right of repossession affords some measure of security against non-fulfilment of contracts, it is counterbalanced by the long credit which frequently has to be granted to hire-purchase customers.

A trader who gives two years' credit runs less risk of incurring bad debts than his competitor who gives four. The longer the period of credit, the greater is the risk that a customer may fall into straitened circumstances and be compelled to surrender the goods; the period over which instalments are spread should, therefore, be ascertained. Where the cardinal principles of sound hire-purchase selling as enumerated on page 10 are strictly observed, much will be done to mitigate losses by default of customers.

Some traders are undoubtedly alive to this important question, as is shown by the following extract from an article by the Transvaal correspondent of *The Times* which appeared in the British Motor Number of that journal dated 12th March, 1929:—

“Another matter engaging serious attention is the enormous extent to which hire-purchase business has increased. Traders say that if kept within bounds this form of business is perfectly sound; but when the deposit is too small and the period over which payments are spread too long, the security is lost, and it becomes a matter of open account, often with people who are undeserving of such credit.”

English commercial circles are not well supplied with statistics regarding bad debts incurred by hire-purchase traders. The widespread popularity of the system is of comparatively recent growth, and in consequence the available information is based on a rather short experience. In America, where the system has for many years played an important part in commerce, losses are said to have averaged only a fraction of 1 per cent of the turnover, but this cannot be applied with any confidence to England as trading conditions are different. The period of credit allowed by many traders in the United States is limited

to 18 months for furniture and shorter periods for articles of a less durable nature. Weekly payments are quite common in America, even amongst high-class traders, but monthly payments are more usual in England, while a substantial initial deposit is usually required there but frequently dispensed with in England.

The subject is of such importance to all concerned, and yet receives so little publicity in this country that, in an endeavour to supply information as to losses through bad debts in hire-purchase trading, the following particulars have been collated from various sources :—

(a) A company whose business was principally to finance sales of motor cars on hire-purchase terms had the following experience :—

		Turnover	Percentage of Losses to Turnover
		£	
Year 1924	..	145,000	0.6 %
1925	..	380,000	0.3 %
1926	..	480,000	0.3 %

In respect of sales amounting to about £375,000 losses in excess of one-quarter per cent. were insured for a premium of £900.

(b) Another company of a similar nature insured against bad debts in excess of 1 per cent., and the losses incurred between 1922 and 1927 were less than this. The turnover was :—

			£
1922	..	..	580,000
1923	..	..	875,000
1924	..	..	1,200,000
1925	..	..	1,000,000
1926	..	..	1,200,000
1927	..	..	1,000,000

For the year 1928 the turnover was nearly £2,000,000 and the bad debts less than 10s. per £100.

(c) A third company which financed miscellaneous sales on hire-purchase terms did not insure against bad debts as the losses incurred were trifling. A reserve of $2\frac{1}{2}$ per cent. on turnover was considered adequate.

(d) A company selling furniture on hire-purchase terms incurred losses by bad debts and legal expenses in connection therewith which compared with the turnover as follows :—

			Turnover	Bad Debts and Legal Expenses
			£	
Year	1923	..	400,000	1.3 %
	1924	..	500,000	0.3 %
	1925	..	575,000	0.3 %

(e) Another company of a similar nature maintained a reserve of 10 per cent. on the outstanding instalments, and the charge in the Profit and Loss Account, which included the increase in the reserve as well as debts written off, amounted to about 5 per cent. of the turnover.

(f) A third similar company showed book debts amounting to £85,000 and losses in excess of $2\frac{1}{2}$ per cent. had been insured for a premium of £1,050.

(g) A company selling pianos by hire-purchase has given its losses from bad debts at less than 1/10th of a penny in the pound.

(h) A Trade Protection Association has estimated that losses by default suffered by its members average less than 2 per cent. of the sales.

Bad debts written off in a particular year will usually relate to the sales of earlier years, and, when sales are

increasing, comparison of losses with the turnover of the year in which the debts are written off shows a lower ratio than if comparison were made with the turnover of the earlier years. None of the years for which figures are given was affected by a period of exceptional trade depression. The full effect of the General Strike of 1926 would not have been apparent until the following year, so that the low ratio of losses in 1926 which is given in the first example affords no guidance as to the probable bad debts in a period of sudden unemployment. The difficulties which might be expected to arise at such a time would probably be accentuated by the return of large quantities of goods, with the result that the value of second-hand articles would be seriously affected. Such a state of affairs, coupled with the reduced purchasing power of the community, might place traders in a position from which they could only extricate themselves at considerable loss.

The risks involved in hire-purchase trading are a topic of constant discussion. A very large portion of hire-purchase sales to-day relate to motor cars and furniture. The percentage of losses incurred in these two branches of the trade is usually small, and is no criterion as to losses which may arise from the sale of other articles of less permanent value, so that the average bad debts experience of a body of traders is no guide to the risk which is run by individual businesses. Much depends upon the manner in which customers are persuaded to make use of the system and the period of credit which is allowed, and conclusions reached with regard to a particular business should therefore be reviewed from time to time in the light of experience.

When comparing the ratio of losses to turnover in different businesses, allowance must be made for variations in the method of dealing with trading profits.

For example, a business might apportion its gross profit over the length of agreements, and when a debt is written off, apply any unearned profit on the relative sale in reduction of the bad debt. The business would then show a lower ratio of loss than if credit had been taken for the whole profit as soon as the agreement was signed. Comparison would also be impossible with a business which, though it apportioned profits over the length of agreements, did not apply unearned profit in reduction of bad debts; the question is reverted to on page 169 where it is pointed out that if uniformity is to be obtained the unpaid portions of gross sale prices should be treated as bad debts, the unearned profit held in suspense (if any) being separately adjusted.

Certain businesses run greater risks than others that customers will return their purchases and this is particularly the case when new inventions are liable to render the goods obsolete, as, for example, in the electrical and wireless trades. The tendency will be for customers to return apparatus which has become out of date and so terminate their liability for further instalments. The second-hand value of such goods would be negligible compared with the original sale price, and a trader placed in these circumstances would probably find it difficult to keep his bad debts at a low level by the sale of repossessed goods. In fact, unless special steps were taken to avoid the return of goods, as by requiring a substantial initial payment or shortening the period of credit, the loss ratio would probably be above the average.

The chairman of a prominent furnishing company recently took the opportunity afforded by the annual general meeting to stress the sound character of the hire-purchase debts which amounted to nearly one million pounds. In the course of his speech he said :—

“ In this regard it should be borne in mind that the amount owing by hire-purchase debtors is a real asset, quite comparable, in my opinion, to book debts of an ordinary business when one takes into consideration the fact that in a business like ours the amounts owing are spread over many thousands of individuals so that the amount due per head is not considerable ; and if credit is wisely given, as has been the practice in the case of your company, and which is demonstrated by the fact of the negligible amount of bad debts this company makes, the amounts owing by the customers of the company are first-class assets.”

It is admitted that many businesses have been managed for a number of years with profitable returns to shareholders, while references to the subject in the public press are punctuated with assertions from those engaged in the trade that their losses are negligible. There is nevertheless an undercurrent of uneasiness which comes to the surface when a situation is revealed such as recently contributed to the failure of a large insurance company in Germany.

The one view found expression at a recent company meeting when the chairman of a finance company, in his speech to the shareholders, said that it had been clear that the financial period under review would show a considerable drop in profits, but the directors had not anticipated anything like the decline that had actually occurred. That decline was due to two factors, one of a general and one of a special nature.

The general factor, he said, was the steady worsening that had occurred in the industrial position of the country, with regard to which a newspaper had written as follows : “ The experience of companies engaged in financing hire-purchase agreements has not been an altogether

happy one, partly no doubt owing to causes over which they have no control, such as depression in various industrial centres."

The instalment sales agreements figured in the accounts at nearly £150,000. It could not be anticipated that when fully liquidated they would produce anything like that figure, and that was why the directors did not feel justified in regarding any portion of the receipts from that source as distributable revenue. What those receipts would amount to it was impossible to forecast. Over 9,000 agreements were being carried, and it might take two or three years before they would know precisely what they were worth.

The chairman went on to say that for the first five years of its existence the company had found the financing of instalment buying extremely lucrative, the holders of the Preferred Ordinary shares having received during the years 1924-28 dividends amounting to 57½ per cent. As events had turned out, the financing of instalment buying of pianos, gramophones and radio sets—the business in which their company was engaged—had proved to be a very hazardous enterprise, mainly owing to the general condition of trade and unemployment which had developed in this country in recent years, and which unfortunately showed no immediate signs of improvement.

One heard of the small losses suffered by companies engaged in financing the hire-purchase of motor cars, but in that case conditions were entirely different, and the class of people who could afford to buy a motor car usually, though not always, had more resources should adversity come than the class of hirers with whom the company had usually to deal.

The chairman further explained that there was also a special factor in the decline in the company's fortunes.

The directors had always protected themselves against the contingency of the hirer not being able to continue his payments by making the suppliers responsible to the company for the due fulfilment of any agreements the company discounted. Unfortunately, one important firm for which they had been discounting agreements became insolvent and was compelled to shut down its business, with the result that in order to get in the money due on the outstanding agreements the company had to shoulder certain of the firm's obligations to the hirers. Although they had been successful in getting in a very large proportion of the money due, the cost of collection and the expenses had greatly exceeded the sum originally contemplated.

The other view is strongly supported in various quarters by persons who state that in their experience there is no difference between the hire-purchase selling of motor cars and of gramophones or wireless sets. Provided that the goods outlast the period of credit and reasonable care is taken to examine the financial standing of each customer, they contend that there is a wide range of articles, many of which do not fall within the category of necessities, which can safely be sold on hire-purchase terms. Exponents of the system claim that it is perfectly sound when administered judiciously, attention being necessary both to granting credit and to the subsequent collection of instalments.

There can be no question that in the hands of inexperienced traders the system is accompanied by grave risks which are not lessened by a desire to obtain business. In an endeavour to secure recognition in a field which is rapidly becoming popular, newcomers may be tempted to offer terms which leave little or no margin for contingencies, and the result can only be injurious to traders and customers alike.

In every branch of commerce serious losses occur from time to time, but there is no outcry to suspend the particular class of trade which has suffered misfortune. For several years past, marine insurance companies have been working under considerable difficulty, and in some cases it is only their substantial reserves which have enabled them to survive, but there is no suggestion that marine risks should not be underwritten. Why then should hire-purchase trading be condemned merely because some firms come to grief through heavy bad debts? The obvious remedy is to exercise care in granting credit to customers and close supervision over the collection of instalments. The effect of a large number of small instalments in arrear is just as dangerous to a business as that of a small number of large instalments. In practice it may be worse, because the cost of collecting small accounts is frequently out of proportion to the sums involved. It is not always appreciated that, when numerous payments are falling due every day, arrears can accumulate in an alarming manner if customers are irregular. Unless overdue accounts are promptly followed up, certain types of customers are quick to take advantage of the latitude allowed, and the knowledge that they will not be unduly pressed for payment is bound to have a harmful effect on the business.

Preparation of Statistics Bearing on Bad Debts

Besides making periodical detailed examinations of the debts, it is important to compile up-to-date statistics which will enable the management to detect any tendency for arrears to increase, and to check the movement before it becomes uncontrollable. The following information prepared at monthly intervals will be found useful for this purpose, especially when tabulated so

that the trend over a period of twelve months or more can be seen :—

- (1) The total instalments in arrear at the end of the month as shown by the Control Account in the private ledger (page 67) and the ratio of the arrears to the instalments falling due for payment during the month.
- (2) The amount of instalments in arrear for one month, two months, three months and so on.^c This information is not easy to obtain, but its utility is obvious, and the work of extracting the necessary particulars can be lightened by providing on customers' ledger accounts a column in which to show the due date of instalments which are paid. Such an arrangement is shown in Example 7, though complications might arise when payments do not correspond with the amounts due.
- (3) The amount of balances outstanding in respect of which no cash has been received for one, two, three or more months.
- (4) A geographical analysis of the arrears, which might be found useful in a business having wide-spread connections, as an increase in a particular area would then receive prominence.

In addition to the foregoing statistics bearing on instalments in arrear, which, needless to say, should be in the hands of the management soon after the end of each month, information should also be available bearing on the bad debts actually incurred and the following is suggested :—

- (1) An analysis of losses between cases where goods have been repossessed on account of non-payment of instalments, or where the debt and the goods have been written off as irrecoverable, or where customers have voluntarily returned goods.

- (2) An analysis of the causes which contributed to bring about the losses, as, for example, sickness, unemployment, or evasion.
- (3) In certain cases dependent upon the nature of the business, an analysis as between different classes of goods might be of considerable assistance in deciding whether to discontinue hire-purchase facilities in connection with a particular article.
- (4) The geographical distribution of losses.

The foregoing are a few suggestions which will enable those responsible for formulating the selling policy of a business to obtain a clear idea of the progress of the hire-purchase trade, and if the indications afforded by the statistical statements are properly interpreted, they should be able to steer a course clear of the dangers which threaten those who seek to navigate the seas of hire-purchase trading.

Method of Determining Loss Arising from Bad Debts

Bad debts charged in the profit and loss account may either represent the monetary loss to the business, that is, the difference between the cost of goods and their value on repossession, less instalments received, or they may represent the difference between the sale prices to customers and amounts paid by them after adjustment for the value of goods repossessed. The former is more in accordance with the theory of hire-purchase, because it ignores the existence of sales and merely takes account of the depreciation of goods after allowance for instalments received from customers; the latter is in keeping with the commercial view that hire-purchase is a form of selling. When a retailer who trades on ordinary credit terms incurs a bad debt, he does not cancel the profit which was included in the

sale and charge only the balance of the debt in his profit and loss account ; he writes off the whole amount in one sum, and there seems to be no logical reason why the same should not be done when the sale is on hire-purchase terms.

If the profit is cancelled so that only the net loss is charged as a bad debt it follows that the sale must be cancelled so that the trading account may correctly show the percentage of profit to turnover. Expenses will have been incurred in connection with the sale, however, such as carriage, wages and probably salesman's commission—the latter is frequently paid even though an agreement lapses. Hence, if the sale is written back, the ratio of expenses to turnover is disturbed. A practical difficulty arises when the profit is apportioned over the period of agreements. Part of the profit on a transaction may have been credited to a closed year and if in the following year the debt were found to be irrecoverable, it would be impossible to cancel the whole of the profit.

It is obvious that in this matter, as in others, uniformity of practice is desirable, and if comparisons are not to be impaired the proper course is to treat as a bad debt the unpaid portion of the gross sale price.

A disadvantage of the "stock system" of keeping hire-purchase accounts is that amounts written off for bad debts are based on the cost price of goods sold, which may give rise to a false impression that losses are below the average.

The system described in this book for preparing the accounts of a hire-purchase business has in view that the trading conditions shall be revealed in detail in the clearest possible manner, not necessarily to the public, but to those responsible for managing the concern, and it is with this object that the preparation of trading and profit and loss accounts on the customary lines is

suggested, any desired apportionment of profits being afterwards made by means of a suspense account.

It must always be remembered, however, that when a bad debt is written off, the trading period to which it is charged must be credited not only with the profit on the relative sale which is applicable to that period, but also with any profit which would have accrued to future periods had events run their normal course. Otherwise a profit is carried forward in suspense which has no relation to instalments falling due. In order to avoid this, bad debts are adjusted in the Running Summary, of Instalments falling due, a transfer of instalments being made from future months to the month in which a debt is written off (see page 51). As the running summary is the basis for apportioning the profit (see page 71) it follows that the month in which a debt is written off receives credit for the whole of any profit held in suspense in respect of that particular transaction. When the apportionment is according to instalments received in cash, separate adjustments must be made for bad debts written off unless an approximate allocation of profits is made by carrying forward a predetermined percentage of the outstanding balances (see page 132).

Doubtful Debts Reserve—Method of Extracting Lists of Overdue Debts and Calculating Reserve

Debts which are known to be irrecoverable will, of course, be written off from time to time as part of the normal routine, but when preparing a balance sheet it is necessary in addition to create a reserve against doubtful debts. Owing to keen competition and the importance of avoiding any suggestion of harsh dealings, retailers are sometimes loath to insist on their strict legal

rights when a customer falls into arrear with his instalments. Rather than take back goods, they not infrequently agree to extend payment of outstanding instalments beyond the period of an agreement, provided they are satisfied with the customer's credentials and as to his inability to pay at the rate originally arranged. They will sometimes agree to the entire suspension of payments for a time if they know that goods are still in a customer's possession. Hence, although in the case of ordinary credit sales failure to pay a debt within the usual time may give grounds for questioning a customer's ability to pay, in the case of hire-purchase sales non-receipt of instalments is not necessarily an indication that a debt is doubtful, as the amount owing may be fully covered by the value of goods which can, if necessary, be repossessed. The value of the goods will always be problematical, however, particularly when they have been in a customer's possession for some time, and it cannot safely be assumed that a debt is covered unless a substantial proportion of the total price has been paid. The amount which should be regarded as necessary for this purpose will vary according to the nature of the goods in each case.

It will be appreciated that an intimate acquaintance with each customer's account is necessary before any useful attempt can be made to estimate the value of the unpaid instalments and the reserve which is required for doubtful debts. Attention will naturally be directed chiefly to cases where payments have fallen into arrear and some indication of the state of affairs can be obtained from the account in the private ledger headed "Sundry Debtors for Instalments due." The balance on the account, as explained in Chapter III, represents only instalments which have fallen due, and is quite distinct from instalments which are not due. From this account

the trend of the overdue instalments can be seen, and any serious and sustained increase in the monthly balance should be regarded as an unhealthy sign.

With a view to obtaining more detailed information about the overdue instalments, they should be tabulated and classified according to their age and the periods of the agreements. Each customer's account must be carefully scrutinised, and if the lists are intelligently prepared they should give a clear view of the state of each debt without further reference to the ledger accounts being necessary. Example 17 shows a useful ruling for sheets on to which the lists can be entered, and in order to demonstrate the advantage of the form let it be assumed that a clerk who has received no special instruction on the subject has extracted the following list of overdue instalments :—

Overdue Instalments 31st December 1928

<i>Customer's Name</i>	<i>Number of Instalments Outstanding</i>	<i>Amount</i>		
		<i>£</i>	<i>s</i>	<i>d</i>
A.	3	6	0	0
B.	6	6	0	0
C.	6	36	0	0
D.	2	6	0	0
E.	3	6	0	0
F.	4	6	0	0
G.	2	5	0	0
		<hr/>		
		£71	0	0
		<hr/>		

It is probable that a person looking at this list without having seen the customers' accounts would consider B., C. and F. to be the most doubtful of the debts, and would be fairly satisfied that the others need not cause immediate apprehension.

Date 31st DECEMBER, 1928 36 Monthly Instalments

Overdue Instalments

Customer's Name and Address	Amount of Original Sale	Number and total amount of Instalments unpaid	Number of Instalments in arrear and amount of each Instalment	Date and amount of last payment	Remarks	Considered very doubtful		Considered slightly doubtful		Amount outstanding
						Amount of Original Sale	Amount outstanding	Amount of Original Sale	Amount outstanding	
A.	£ s d 72 0 0	20 40 0 0	£ s d 3 2 0 0	£ s d 13/9/28 2 0 0		£ s d .. 0 0	£ s d .. 0 0	£ s d 72 0 0	£ s d 40 0 0	£ s d 40 0 0
B.	36 0 0	34 34 0 0	6 1 0 0	20/6/28 1 0 0		36 0 0	34 0 0	..	..	..
C.	216 0 0	18 108 0 0	6 6 0 0	20/6/28 5 0 0		..	..	..	..	..
E.	72 0 0	35 70 0 0	3 2 0 0	13/9/28 2 0 0		72 0 0	70 0 0	..	..	..
F.	54 0 0	26 39 0 0	4 1 10 0	12/12/28 1 10 0		..	..	..	..	..
						108 0 0	104 0 0	72 0 0	40 0 0	40 0 0

Date 31st DECEMBER, 1928 8 Monthly Instalments

Overdue Instalments

Customer's Name and Address	Amount of Original Sale	Number and total amount of Instalments unpaid	Number of Instalments in arrear and amount of each Instalment	Date and amount of last payment	Remarks	Considered very doubtful		Considered slightly doubtful		Amount outstanding
						Amount of Original Sale	Amount outstanding	Amount of Original Sale	Amount outstanding	
D.	£ s d 24 0 0	7 21 0 0	£ s d 2 3 0 0	£ s d 10/10/28 3 0 0		£ s d 24 0 0	£ s d 21 0 0	£ s d ..	£ s d ..	£ s d ..
G.	20 0 0	2 5 0 0	2 2 10 0	6/8/28 2 10 0		20 0 0	5 0 0	..	..	..
						44 0 0	26 0 0			

EXAMPLE 17

If, however, the list is recast, as shown in Example 17, a much more reliable opinion can be formed of the state of the accounts.

The list now discloses debts of five categories :—

(1) Those on which very few instalments have been paid, with the result that the depreciation of the goods is not covered.

B. and E. have agreements for 36 months. They have paid 2 and 1 instalments, and are 6 and 3 months in arrear ; they have, therefore, been in possession of the goods for 8 and 4 months respectively.

D. has an agreement for 8 months, which probably indicates that the goods are of a non-permanent nature and therefore of doubtful value if repossessed. He has paid only 1 instalment and is 2 months in arrear.

Prima facie, these three debts should be regarded as doubtful, because sufficient instalments have not been received to cover depreciation of the goods. Although there is usually a clause in agreements which requires customers to pay a stated percentage of the instalments in the event of the return of goods, it is not always practicable to insist on compliance with the condition.

(2) Those on which not less than one-quarter of the price has been paid, and instalments are not seriously in arrear.

In this category may be placed A. and F. The instalments paid by these two customers, taken in conjunction with the periods they have been in possession of the goods, indicate that in the event of repossession becoming necessary, the second-hand value of the goods would be sufficient to reduce any loss to a minimum.

(3) Those on which not less than one-half of the instalments have been paid, as for example, the case of C. Although this customer is 6 months in arrear it is improbable that any loss would be experienced if the goods had to be recovered.

(4) Those which, although several months in arrear, have been recently reduced.

F. is an instance of a customer who has recommenced paying his instalments after being in arrear. In such a case, although the arrears are not paid off in addition to the monthly instalments falling due, it is usually found that so long as payments are regular the debt need cause little apprehension. The cessation of payments may have been caused by illness or other unforeseen circumstances beyond the customer's control.

(5) Those where the term of the agreement has expired.

The list shows that although G. is only two instalments in arrear, they are the only two owing by him. As his last payment was made in August, the agreement presumably expired not later than October; he has therefore had the use of the goods for at least 10 months, and as they are probably of a non-permanent character, the debt must be regarded as of very doubtful value.

It will thus be seen that the first-mentioned list of overdue instalments was devoid of all useful information and in some respects misleading. For example, there was nothing to distinguish A.'s debt from that of E., although the former is much sounder than the latter, nor did it disclose that G.'s agreement had expired.

In order to estimate the amount required as a reserve for doubtful debts, the four right-hand columns in the

Example should be completed by someone familiar with the circumstances, preferably the person whose duty it is to attend to the collection of overdue instalments.

It is suggested that the broad principle to follow should be to enter all debts falling within Classes 1 and 5 in the columns headed "Considered very doubtful" and those in Class 2 in the columns headed "Considered slightly doubtful." For the present purpose, debts in Classes 3 and 4 will be regarded as good, but naturally these suggestions might need adapting to meet particular cases.

Referring to the list headed "36 monthly instalments," which will probably cover articles of a durable nature, the amount to be considered very doubtful following the above suggestions would be £104, consisting of £34 due by B. and £70 due by E.

These debts fall within the class on which few instalments have been paid, and a substantial reserve is required to cover depreciation of the goods. Assume for purposes of illustration that second-hand goods similar to those likely to be included in such agreements could be sold for about 70 per cent. of their original price, and that allowance must be made for gross profit of 25 per cent. on resale. This would mean that the value of the goods to the business on repossession would be about $52\frac{1}{2}$ per cent. of their first sale price of £108, or £56 14s., so that the reserve required on these debts would be £47 6s.

The amount to be treated as slightly doubtful would be £40, consisting of A.'s debt. Although F. falls within the second category he is also within the fourth, and can therefore be disregarded. The second-hand value of these goods would perhaps be somewhat less than in the cases just considered, as they will have been in the customer's possession for a longer period. Placing it at 45 per cent. instead of $52\frac{1}{2}$ per cent., the value of the

goods to the business on repossession would be £32 8s. The reserve required on A.'s debt is therefore £7 12s.

In the case of short-term agreements, too high a value should not be placed on the goods as they are likely to be of a non-permanent character and unsuitable for sale in a second-hand condition. It must not be overlooked that the term of some agreements may have expired so that the goods will have been used by the customers for perhaps 12 months or more.

Applying this procedure to the whole of the instalments in arrear, the doubtful debts reserve will be based on estimates which, though not necessarily accurate, may at least be said to be the result of a genuine effort to deal with a difficult problem.

In addition to the reserve so ascertained, a general reserve should be created by way of a percentage of the instalments due from customers who are not in arrear, as a certain number of accounts are likely to become bad although at the date of the balance sheet they may give rise to no anxiety. The rate at which the general reserve is to be calculated must be decided upon the merits of each case. The amount of bad debts written off in previous years may afford an indication as to what provision is necessary, and guidance may also be obtained from the rate of interest which is added to cash sale prices of goods in order to ascertain hire-purchase prices. A high rate of interest will be *prima facie* evidence that a heavy risk is involved, although it should be observed that the converse does not necessarily hold good as a low rate of interest may be merely a nominal charge.

It will, of course, be understood that the number of instalments which may be in arrear before a debt is considered doubtful will vary according to the attitude adopted in particular businesses towards overdue payments. The whole question depends to some extent

on personal opinion, but enough has been written to show the advisability of approaching it with a desire to find out the true state of affairs rather than to shirk what is bound to be an arduous task by making a reserve at a flat rate of, say, 2 per cent. and hoping for the best.

When Profits are Apportioned—Adjustment for Doubtful Debts Reserve

In the foregoing remarks no account has been taken of a reserve which may exist in the books consisting of unearned profit carried forward to future periods. Assuming that net profit at the rate of 10 per cent. is spread over the period of agreements, there will always be an amount in suspense equal to 10 per cent. of instalments which have not fallen due for payment. It does not follow, however, that the doubtful debts reserve can be reduced by an equivalent sum, as the balances against which the reserve is required will include instalments which are overdue, the gross profit on which will have been transferred from suspense to the credit of profit and loss account. In fact, in the case of short-term agreements, it may be found that many of the balances are entirely overdue, so that the existence of a reserve for unearned profit would not have much influence on the amount required as a reserve for doubtful debts.

While great care should therefore be exercised before deciding that provision need not be made for the whole of the anticipated loss, in appropriate cases an adjustment may be made for unearned profit held in suspense. It is inadvisable, however, to reduce the doubtful debts reserve; rather should the amount of profit transferred from suspense account to profit and loss account be increased as was done in the *pro forma* accounts given on page 76. The gross charge for bad debts is then

shown and, in addition, the percentage of outstanding instalments considered doubtful is revealed. If the reserve is reduced below the amount required on the ground that the unearned profit carried forward in suspense is tantamount to a reserve for doubtful debts, the effect is to confuse the accounts and convert an unspecified part of the unearned profit from a free reserve into a reserve earmarked for a definite purpose. Losses suffered by bad debts ought to be readily ascertainable, and, if it is desired to spread the profit on hire-purchase sales over the length of the agreements, the latter should be an entirely separate operation considered solely on its merits without being allowed to confuse other items in the accounts.

The additional amount which, as suggested above, may be transferred from suspense account, must be written back in the following year in order to restore to its original amount the profit held in suspense. The writing back is necessary so that the profit may be available for allocation to the period when the debts are actually written off, and the effect is as follows:—

Assume sales for the year 1 are £12,000 and at the end of the year customers' accounts amounting to £2,400 are considered doubtful and are definitely written off as bad at the end of the year 2.

The doubtful debts reserve at the end of year 1 is estimated at £900, thus:—

Sale Price of Goods	..	..	..	£2,400
Cash received for Instalments	..	..	..	300
				<hr/>
				2,100
Value of Goods on Repossession	..	..	..	1,200
				<hr/>
Loss	..	..	..	£900
				<hr/>

Instalments fall due as follows:—

				Total	Good	Doubtful
				£	£	£
Year 1	..	..	..	3,000	2,400	600
„ 2	..	..	..	4,000	3,200	800
„ 3	..	..	..	4,000	3,200	800
„ 4	..	..	..	1,000	800	200
				<u>£12,000</u>		

At the end of year 1 there will be instalments not yet due on the doubtful accounts amounting to £1,800. Net profit at 10 per cent. is spread over the length of agreements and there will therefore be £180 in suspense in respect of the doubtful debts which has to be credited to year 1 as a set-off against the reserve of £900. The profit and loss account for the year 1 would therefore be:—

	£		£
To Purchases and Expenses 10,800		By Sales 12,000	
„ Net Profit carried to Suspense Account.. 1,200			
	<u>£12,000</u>		<u>£12,000</u>
To Reserve for Doubtful Debts 900		By Transfer from Suspense Account, 10 per cent. on £3,000 Instalments due .. 300	
		„ Adjustment for Doubtful Debts .. 180	
			<u>480</u>
		„ Loss for the year .. 420	
	<u>£900</u>		<u>£900</u>

At the end of the second year when the debts are written off as bad, the instalments which have not fallen due, i.e. £1,000, will be transferred in the Running Summary of Instalments from the third and fourth years to the second.

The profit to be credited to the second year is therefore 10 per cent. on £5,000 or £500				
<i>Deduct</i> Adjustment for Profit on Doubtful				
Debts in year 1, now written back ..				180
				<hr/>
				£320
This is equivalent to 10 per cent. on the instalments falling due in respect of good debts, i.e. £3,200.				
The profit to be credited to year 3 is similarly 10 per cent. of £3,200 or 320				
The profit to be credited to year 4 is 10 per cent. of £800 or 80				
				<hr/>
				720
<i>Deduct</i> Loss in year 1				420
				<hr/>
Total Profit spread over 4 years.. ..				£300
				<hr/>
The net profit carried to Suspense Account was £1200				
<i>Deduct</i> Bad Debts				900
				<hr/>
				£300
				<hr/>

In practice it is not possible to make a reserve for the exact amount of bad debts in a particular year and the final loss is only known when the debts are written off, nor is it possible without considerable trouble to ascertain the precise amount of instalments not yet due which are included in the doubtful debts, but subject to these limitations it will be seen that by the above method the profit on agreements which are carried to completion is spread over the period of their duration, whilst the loss on lapsed agreements is charged against the year in which the customers commenced to default.

It is contended that the foregoing is the true basis to adopt when it is desired to apportion the profit on hire-purchase sales, since whatever views may be held as to the necessity for this course, there can be no connection between losses on certain agreements and profits on others.

Creation of Doubtful Debts Reserve by Means of a Credit Insurance Fund

An alternative treatment of bad and doubtful debts is to charge a flat rate of, say, 2 per cent. on the turnover each year as a reserve for losses which may be incurred. It is not an unreasonable argument that in fixing hire-purchase selling prices one of the items of cost which is taken into account is bad debts, and that as a corollary a corresponding charge, somewhat akin to a credit insurance premium, should be made in the profit and loss account before there can be any net profit to apportion over the length of agreements.

An analogy is the case of a shipping company which does not insure its fleet, but creates an internal insurance fund by means of an annual charge against profits of a sum equivalent to the premium which would have to be paid to cover the risk with an independent company. At the same time this course, while suitable for creating funds to meet losses of infrequent occurrence, scarcely seems appropriate when applied to the bad debts of a trading company. Bad debts are a normal trading risk, the incidence of which is partly dependent on the quality of the management and other variable conditions affecting the business, and in this respect they are far removed from marine or fire risks. It therefore seems that although at first sight a credit insurance fund may appear to have advantages, yet it scarcely leads to a correct presentation of the trading results of each indi-

vidual year, which should show as far as possible what bad debts have been incurred. When in spite of this drawback the plan is adopted, an annual examination of the debts in order to ascertain what reserve is required cannot be dispensed with, as it is still necessary to know that the credit insurance fund is adequate for its purpose.

Free Insurance Cover

Closely related to the risk of incurring bad debts is that arising from offers of free fire and life insurance which are a common feature of agreements relating to sales of furniture.

FIRE INSURANCE

As the legal title to the goods remains vested in the seller until all instalments have been paid, it is necessary for his protection that they should be insured against loss by fire, otherwise in the event of their destruction he would have no claim against a customer for instalments of hire which had not fallen due for payment. The value of a trader's interest in the goods is the full sale price, but the amount of his loss in the event of their destruction would be limited to the unpaid instalments, and it is therefore only necessary for him to insure up to that amount.

The customer also has an insurable interest but only to the extent to which instalments of hire have become due, as this would be the limit of his loss.

The situation thus created can be met in three ways :—

1. The agreement may throw the onus of insuring on the customer. If he fails to keep the goods covered he would be liable to the trader for breach of contract, the measure of which would be the loss incurred by the latter, i.e. the amount of any instalments unpaid. When the customer is required to insure the goods,

it is usual to allow him to deduct the premium from his instalments. This method is not satisfactory from the trader's point of view, as he might experience difficulty in recovering from his customer.

2. The trader may arrange for an insurance company to cover the full value of the goods for the joint benefit of the trader and the customer according to their respective interests. In this case, a form of policy is usually issued to the customer free of charge.
3. The trader may insure only his own interest in the goods, leaving the customer to insure his interest separately.

Whichever course may be adopted, no unusual treatment in the accounts of the business is involved, since the premiums paid would be treated as ordinary outgoings.

LIFE INSURANCE

It has been explained in Chapter II that the offer of free life insurance operates, in the event of the death of a customer during the currency of an agreement, to free his estate from any liability for instalments which have not fallen due, the goods at the same time becoming part of his estate. It is not unusual for the benefit of this offer to be extended to cover the death of the hirer's husband, if the hirer be a married woman dependent on him, or to be limited to persons between certain ages.

The trader may arrange for an insurance company to issue a short-term policy to each customer providing for payment on death of an amount equal to the instalments which have not fallen due; or he may draw up the hiring agreement so that instalments cease at death, and then insure himself against the risk of loss resulting from death of his customers. In either case he will pay

a premium which will be treated as an expense of the business.

On the other hand, the trader may decide not to insure the risk at all, and if he does this, he should create a reserve out of which to meet losses as they arise. The amount of the reserve to be set aside for the purpose should be based on the premium charged by insurance companies which is at a flat rate of ten shillings per £100 per annum calculated on the value of the goods sold, irrespective of the age of customers, so that in the case of 3-year contracts the premium would be thirty shillings per £100. In ascertaining the reserve, it may be assumed that one-quarter of the premium is required to cover commission, expenses and profit of the insurance company, which leaves three-quarters to meet claims. It must further be remembered that the premium covers the risk for three years, but that the average unexpired term of the agreements in force at the date of a balance sheet might be only 18 months. In a business with an increasing number of new agreements each year, the reserve, to be adequate, should be based on a period of two years. The reserve required to cover the risk that instalments included in the balance sheet may not be received owing to the death of customers is, therefore, a sum equal to fifteen shillings per £100 on the amount of the outstanding instalments, calculated in the following manner :—

	s	d
Premium charged to cover £100 for 3 years	30	0
<i>Deduct :</i>		
Loading for commission expenses and profit	7	6
	<u>22</u>	<u>6</u>
Equivalent amount to cover the risk for	s	d
2 years being 2/3rds of 22s. 6d.	15	0

It is not necessary to charge against the profits of each year the equivalent of the premium on the year's sales. Provided that losses are written off as they arise, the reserve on the debts of the earlier years will be released as the relative agreements expire, and it is sufficient if the total reserve is maintained at a sum equal to fifteen shillings per £100 on the whole of the outstanding debts.

CHAPTER VIII

PUBLISHED ACCOUNTS

VIII.—PUBLISHED ACCOUNTS

IT is instructive to examine the published balance sheets of companies which conduct hire-purchase business and to compare the manner in which they are drawn up for presentation to shareholders. There are included in the appendix several *pro forma* examples of balance sheets which have been prepared with a view to showing methods in common use, and illustrating variations in points of detail which are found in practice.

The process of standardisation has not yet reached a stage in England when businesses of a similar type adopt a uniform system of accounts. Attempts are made periodically to draw up a common form of balance sheet, but apart from insurance companies, building societies and certain statutory, parliamentary and public utility companies, such efforts have met with little success.

The lack of uniformity in the treatment of hire-purchase transactions has already been discussed, and although the idea of standard treatment is attractive, the difficulties which stand in the way are very great and may almost be said to be insurmountable. A prosperous company is unlikely to change its methods merely to satisfy public curiosity and facilitate comparison with others, while a less successful concern would not welcome proposals likely to lay stress on its financial weakness. Small traders are often exceedingly reluctant to modify their methods even when opportunities for improvement are obvious, while serious difficulties are encountered by traders with a large volume of business owing to the effect which the change may have on profits during the period of transition and the necessity in some cases for reopening the accounts of previous years.

Although the intricacies of modern business conditions

thus preclude a standard form of account, it should not be difficult to find a common form of wording for use in balance sheets to describe the outstanding instalments receivable under hire-purchase agreements. The practice of including such instalments under the heading of Sundry Debtors has been the subject of criticism on the ground that they are not debts, but more accurately represent the trader's interest in the goods. Published balance sheets reveal a wide variety of phrases, all presumably intended to describe the same class of transactions, and the following have been selected at random :—

Goods on hire (less payments on account).

Hirers' balances (secured by title to vehicles).

Book debts including amounts due under hire-purchase agreements.

Sundry debtors including debts on deferred payments.

Debtors (mainly covered by hire-purchase agreements).

Sundry debtors and debit balances.

Having regard to the special nature of hire-purchase agreements, inclusion of future instalments in Sundry Debtors cannot be altogether free from objection. The other extreme is found in the description "Goods on hire," and, as showing that this wording is not entirely beyond criticism, it is of interest to refer to the case of *Drages Limited v. Commissioners of Inland Revenue* (*Accountant Tax Cases*, Vol. 6, 727). The case concerned the amount of stamp duty payable on an agreement for the sale of the business of David Drage & Sons, Ltd. to Drages Limited. Included among the assets undertaken to be transferred by the agreement were the instalments on various hire-purchase agreements which would be receivable after the date of transfer, and the question arose whether the proportion of the consideration

which had been allocated to these instalments was exempt from stamp duty as being attributable to goods or merchandise. Mr. Justice Rowlatt held that the consideration for the instalments was paid in part for the goods which were the subject of the hire-purchase agreements and in part for the interest which the company had in the agreements, and the amount which represented the goods could be estimated by reference to the chance that the goods would be returned. He took the view that the consideration paid could be divided into two parts: (a) the interest in the goods subject to the hiring agreements, and (b) the benefit of the agreements; and that the consideration for the goods alone was to be determined bearing in mind the fact that the property retained in law was destined to be lost beneficially unless the hirer defaulted and returned the goods.

It appears to be clear from this judgment that there is no legal justification for regarding the whole of the instalments as representing the value of the stock of goods on hire. If in a particular case experience showed that 1 per cent. of all goods sold were returned by customers, then at any given date the proportion of instalments outstanding represented by goods would be 1 per cent. and the remaining 99 per cent. would be applicable to the benefit of the agreements. Having regard to all the circumstances it seems that the description most suitable for use in a balance sheet is "Instalments under hire-purchase contracts."

As was indicated in the *pro forma* balance sheet on page 76, the instalments should not be included among the assets at a higher figure than their estimated value, and the book figures should, therefore, be reduced by such reserves for doubtful debts and discount as are necessary to reduce them to their present value at the date of the accounts. Reserves for the cost of collecting

instalments fall within the same category as reserves for accruing or outstanding expenses and should therefore be included with creditors.

Profit on the unexpired portions of hire-purchase transactions carried forward to future periods (if any) is in the nature of unearned profit and should be shown separately on the balance sheet. To group the item with creditors would conceal the amount of current liabilities, and would contravene Section 124 (1) of the Companies Act, 1929, which requires the general nature of the liabilities to be indicated; to deduct the profit from the instalments outstanding, showing only the net balance in the accounts, would understate the value of the assets and conceal from shareholders the amount of the reserves and variations therein.

If both the amount of the instalments and the profit carried forward are shown, the rate of profit can be approximately calculated. In the *pro forma* balance sheet on page 76 the rate is about $9\frac{1}{2}$ per cent., which is very close to the actual rates employed on page 73. Probably the information which would thus be available to competitors is too uncertain to be of much value to them, but if it were desired to conceal still further the rate of profit, a single item could be included in the balance sheet for "Trade debtors including instalments under hire-purchase contracts, less reserve for doubtful debts."

It will be observed that in the second example included in the Appendix, a reserve for bad debts has been combined with the general reserve account into one amount instead of being deducted from the book value of the hire-purchase instalments. All reserves are, as a last resort, available to meet losses incurred by a business, and it may therefore be argued that it is logical to amalgamate them into one figure and to have regard to the position of the company as a whole. Such a course also gives an oppor-

tunity for strengthening the position of a company by making provision for doubtful debts in excess of the amount required to meet known losses. As against these considerations, it must be appreciated that a balance sheet prepared on such lines would presumably include the hire-purchase instalments at their full book value before deducting reserves, and might give rise to misunderstanding. The effect on the published profits of a company also has to be considered. Emphasis was laid in earlier chapters on the desirability of charging in the profit and loss account the full reserve necessary to reduce the book value of outstanding instalments to their estimated realisable value; when such amounts are included with transfers to general reserve and deducted from profits as an appropriation on the balance sheet, some doubt as to the earning capacity of the business might arise in the minds of persons who were unfamiliar with the exact basis on which the accounts had been prepared.

A suggestion with regard to presentation of the profit and loss account was put forward on page 103 which might advantageously be adopted when it is desired to carry forward the profit applicable to outstanding instalments, and at the same time to show in the profit and loss account the results of the year's trading before apportionment of profits over the length of agreements.

The desirability of standardising a suitable form and phraseology in accounts is not so academic as may perhaps be thought. Balance sheets of limited companies circulate among members of all classes of society, many of whom have a very imperfect idea as to their meaning and as to the business operations which they reflect. At a recent company meeting, a shareholder who had drawn attention to the large increase in sundry debtors appeared surprised to learn that it was occasioned by

the inclusion of hire-purchase instalments, but unfortunately he did not enlighten the meeting as to where else he expected them to appear. Criticisms and discussions which tend to elucidate misunderstanding and standardise suitable forms of wording are therefore all to the good, but when making comparisons between balance sheets it should be remembered that circumstances vary in different cases.

None know better than professional accountants what careful consideration has to be devoted to the wording of a balance sheet before it can be reported to show a true and correct view of the state of a company's affairs. At the same time they are not concerned in their capacity as auditors with the prudence of a specific course of action nor with the management of a business. They may not wholeheartedly endorse the principles adopted in keeping accounts or the form in which a balance sheet is presented, and although they will naturally make known their views to the directors, they have no power to insist upon their recommendations being adopted. If, in their opinion, a balance sheet as prepared by the directors shows a true and correct view of the state of a company's affairs, then, merely because the auditors think that certain items might have been better described, they cannot justifiably qualify their report on the accounts although it is the only means at their disposal of expressing an opinion to the shareholders as a body.

CHAPTER IX

INCOME TAX

IX.—INCOME TAX

JUST as there are differences of opinion among traders and professional accountants as to the correct treatment of hire-purchase transactions, so it is perhaps scarcely surprising to find that Inspectors of Taxes have not hitherto been unanimous in their views on the subject. Traders have been obliged to make the best settlement possible with the particular Inspectors dealing with their assessments, and to endeavour to obtain acceptance of their accounts in the form in which they had been prepared. This state of affairs has led to diversity of practice, and concessions allowed to one trader have occasionally been refused to others, but certain broad principles have met with fairly general acceptance.

Traders who treat hire-purchase transactions as cash sales and credit the profit for income-tax purposes at the time of sale should be allowed to charge against the profits a reserve for discount to reduce the instalments to their present value at the date of the accounts; they should also be entitled to a reserve for the cost of collecting the instalments. Circumstances may arise when such allowances are opposed on the ground that reserves are not admissible deductions for income-tax purposes. While this principle is now well established, it is scarcely applicable to the case under discussion. The reserve for discount is no more than a means of ascertaining the value at which instalments are to be included in the accounts, and the reserve for cost of collection falls in the same category as reserves for unpaid rent or other expenses, to the inclusion of which no objection is ever raised.

When interest is added to cash prices in order to ascertain hire-purchase prices, no objection should be

raised by Inspectors to apportionment of the interest over the length of agreements. There are numerous instances where computations have been agreed on this basis, and it may be mentioned that the amount of interest which accrues during the year and is credited in the accounts forms part of the ordinary trading receipts and is not assessable separately as interest under Case III of Schedule "D."

It is with regard to the creation of a general reserve against loss on hire-purchase transactions that greatest difficulty has been experienced in the past when settling assessments. Sometimes a reserve for doubtful debts of, say, 20 per cent. was created, or the profit on sales was apportioned over the length of agreements with similar effect. In either case, unless evidence could be produced that a substantial part of the debts was doubtful, objection to the reserve was likely to be raised by Inspectors.

It has, however, become a fairly general practice to allow apportionment of profits in accordance with the stock system which is explained on page 133, the distinctive feature of which is that profit is brought into account as instalments *fall due for payment*. The fact that traders are allowed to carry forward profit in suspense is regarded as meeting their claims to an allowance for a doubtful debts reserve, and the arrangement has worked satisfactorily in practice.

The Hire Traders' Protection Association has recently concluded an arrangement with the Board of Inland Revenue whereby the profit on hire-purchase transactions may be credited to the profit and loss account as instalments are *received*, a method which represents a marked advance over those previously in force. The following is a copy of a letter from the Board in which the basis of the scheme is defined :—

“ Inland Revenue,
East Wing,
Somerset House, W.C.2.
9th January 1929.

C.I. 811/63
HCS/7
Dear Sir,

HIRE-PURCHASE AGREEMENTS

With reference to your letter of 20th September last, I am now informed that where a retail trader adopts in his own books the method of spreading the profits on hire-purchase transactions over the term of the agreement in the manner suggested by your association, the Board of Inland Revenue, subject to the concurrence of the District Commissioners concerned, will not object to its being followed in computing the profits for income-tax purposes.

In the case of a trader who has previously adopted a different method, the Board will not object to the allowance in the year in which the change is made of the full reserve required by the new method, any reserve previously allowed being brought back to the credit of the account.

Yours truly,
(Sgd.) H. C. SURFLEET,
Senior Inspector of Taxes.

The Secretary,
Hire Traders' Protection Association,
27 Chancery Lane, W.C.2.”

The method of spreading the profit suggested by the Association was to charge against revenue for tax purposes a sum equal to the gross profit percentage on the outstanding instalments under hire-purchase agreements; such gross profit percentage to be as shown by the hire-purchase trading account of the trader each year.

The salient features of the scheme are :—

1. It applies only to hire-purchase sales; deferred payment sales are not included.
2. It applies only to retail traders who adopt in their books the method of spreading profits over the term of agreements.

3. The charge against revenue is to be calculated each year as a percentage on outstanding instalments, such percentage to be equivalent to the rate of gross profit shown by the hire-purchase trading account for the year ending on the date of the balance sheet.
4. When a mixed trade is carried on, a separate trading account must be prepared for hire-purchase transactions.
5. Adoption of the scheme by a trader is subject to the concurrence of the District Commissioners.
6. The scheme is not obligatory, and it is entirely at a trader's option whether he adopts it. He is at liberty to make any other arrangement acceptable to the Inspector of Taxes concerned.

The particular method of spreading profits which has been adopted for the purpose of the scheme has the advantage of simplicity, and having already been considered in detail on page 131, calls for no further comment. It should be observed, however, that the scheme requires the profit carried forward in reserve to be calculated as a percentage of the outstanding instalments, based upon the rate of gross profit of the last completed trading period. As has been pointed out, the result is that in respect of instalments not due at the end of a year and still outstanding at the end of the following year, profit is carried forward at different rates. The importance of this factor as an influence upon the amount of the profits will vary according to the circumstances of each business.

The change from the method hitherto adopted by a trader to that laid down in the scheme may be made at any time, and when the change takes place the full reserve which is required may be charged in the accounts for the year, any reserve previously allowed being brought back to the credit of the accounts. In cases where the

adjustment results in a loss being shown for the year in which the change is made, the loss may be carried forward and set off against assessments for the next six years under Section 33, Finance Act, 1926, or may form the subject of a repayment claim under Section 34 of the Income Tax Act, 1918.

A somewhat difficult question arises in connection with the sale of pianos and mechanical appliances on terms which involve free tuning or maintenance for a period. Taxpayers claim that the liability thus undertaken is a definite factor which has to be taken into account in determining the profit on sales, and that a reserve should be allowed at the end of a year for the unexpired liability. Inspectors of Taxes have been found to contest this view, however, on the ground that there is no fixed and determined liability and that the amount cannot be measured, it being a well-defined rule that no allowance can be made for contingent liabilities until they actually arise. There is perhaps some force in this argument when applied to cases where the nature of the maintenance service is dependent upon breakdowns in the appliances, but when the service involves a definite undertaking to tune pianos each quarter or to inspect and overhaul appliances at fixed intervals, the value of the service to be rendered is capable of accurate determination by reference to the normal charge made to customers in cases where no undertaking has been given, and is in no sense a contingency.

A question which is of indirect interest to sellers of goods on hire-purchase terms is the allowance for hire which may be claimed by traders who purchase goods for use in their business. As long ago as 1913, in the case of *Darngavil Coal Co. Ltd. v. Francis* (7 T.C. 1) a claim was advanced to charge against profits of the

company for income-tax purposes the annual payments made under a hire-purchase agreement relating to the acquisition of railway wagons. It was held that the payments could be divided into two parts (a) the consideration paid for an option to acquire the wagons on the termination of the agreement and (b) the consideration paid for the use of the wagons; and that in so far as the payments represented consideration for the use of the wagons during the period of an agreement they were admissible as a deduction in computing the company's profits for the purposes of Schedule "D."

Following this case, a scheme was approved by the Board of Inland Revenue whereby the difference between the cash price of the wagons and the total amount payable as instalments under the hire-purchase contract may be charged in the accounts as hire in equal amounts over the period of the contract. The following is a copy of the form of agreement which has to be signed by traders wishing to take advantage of the scheme:—

RAILWAY WAGONS

HIRE-PURCHASE

SCHEME for determining the income-tax allowances to be granted in respect of payments made in acquiring wagons under hire-purchase agreements.

1. The lessee of wagons under a hire-purchase agreement shall furnish to H.M. Inspector of Taxes a copy of the agreement together with a certificate from the wagon builder, or other satisfactory evidence, as to the price at which the wagons would have been sold for cash at the date of the agreement, hereinafter referred to as the initial value.

2. The difference between the initial value and the aggregate amount payable under the agreement shall be treated as "hire," and allowed in equal annual amounts spread over the term of the agreement.

3. Depreciation shall also be allowed on the initial value from the beginning of the agreement in accordance with the provisions of the Income Tax Acts.

4. In the event of any wagons under a hire-purchase agreement being purchased outright before the termination of the agreement or being returned to the lessor, the allowance for hire shall cease from the date of such purchase or return, and if returned the allowance for depreciation shall thenceforth cease.

5. If any such wagons shall be "refinanced," the allowance for hire under the agreement thus terminated shall cease and a fresh allowance shall be made for the period of the new agreement to be determined by taking the difference between the amount at which such wagons are refinanced at the date of the new agreement and the aggregate amount payable under the new agreement, and spreading the said difference evenly over the term thereof. The allowance for depreciation to be continued without reference to the new agreement.

6. Where any wagons are the subject of hire-purchase agreements current at the date of the adoption of this scheme or during any of the preceding years upon the profits of which any income-tax assessments are computed, and no allowances for hire have been made in respect of the payments under such agreements, the amount which would have been allowable annually for hire had this agreement been in force at the date of the hire-purchase agreement shall be ascertained and the appropriate amount shall be allowed annually for the remainder of the term of the hire-purchase agreement. Provided that, where the depreciation allowance in respect of such wagons has been calculated on the aggregate amount payable under the agreement, the total of the amounts allowable as hire under this clause shall be deducted from the said aggregate amount in computing future allowances for depreciation.

Should satisfactory evidence of the initial value of the wagons at the date of the agreement not be available, such value may be computed from the aggregate amount payable under the agreement on the basis of a five per cent. interest table.

7. Where any wagons are the subject of hire-purchase agreements current at the date of this agreement, and allowances have been made in any previous year in respect of the payments under such agreements otherwise than in the form of depreciation, the aggregate amount of such allowances shall be deducted from the aggregate amount allowable under this scheme as "hire" in respect of such agreement, and the balance only shall be allowed in equal annual amounts spread over the remainder of the term of the agreement.

Provided that any adjustment of the capital value on which depreciation is allowable, rendered necessary by the operation of this clause, shall be made as provided in Clause 6.

GENERAL

8. The cost of reconstruction and all renewals of parts shall be allowed as repairs, except so far as they constitute an extension, enlargement, or other similar improvement of value.

9. Where such reconstruction and renewals are allowable under this scheme they shall be allowed notwithstanding that the cost thereof may not have been debited in the company's accounts against revenue.

10. Where "dead-ends" are converted into "spring-buffers" the total cost of such conversion shall be allowed less £5 per wagon, which latter sum shall be treated as the capital value of the improvement, and shall be added to the value of the wagons for the purpose of computing the annual allowance for depreciation.

11. This scheme shall take effect for the year. and in calculating the assessable liability shall be applied to the accounts for each of the five years or other period on the average of which the said liability falls to be computed.

12. The rate of depreciation when agreed upon shall apply to all wagons whether the subject of hire-purchase agreements or not.

(We) desire to adopt the above scheme and hereby undertake to fulfil the conditions thereof.

Dated

Form No. 175

It will be observed that in addition to the allowance for hire, wear and tear may be claimed on the full cash price of the wagons from the date of entering into the hire-purchase contract. A similar arrangement can be made by traders who are purchasing machinery, accounting machines, or similar articles on hire-purchase terms for use in their business, and the following example shows the method of calculating the allowances :—

Agreement to hire 100 wagons for seven years from 1st April, 1929 at a yearly rental of £1,834 11s. 8d., payable quarterly, with an option to purchase the wagons for one shilling each at the end of the term.

	£	s	d
The aggregate amount payable under the agreement is	12,842	1	8
The initial value is ascertained to be	10,000	0	0
Allowance for "hire"	<u>£2,842</u>	<u>1</u>	<u>8</u>
Annual allowance for "hire" chargeable against profits	406	0	3
Assuming a company's accounts are made up to 31st December 1929 the allowance in that year would be :—			
Three-fourths of £406 os. 3d. or £304 10s. 2d. .			

The wear and tear allowance is $6\frac{1}{4}$ per cent. per annum on the written-down value of the wagons based on the initial value of £10,000 commencing in the year 1929-30.

APPENDIX

PRO FORMA EXAMPLES OF BALANCE SHEETS FOR PUBLICATION

A. RETAILER, LTD.

BALANCE SHEET, 31ST DECEMBER 1929

	£		£
SHARE CAPITAL—		FREEHOLD PROPERTIES AT COST	120,000
Authorised and Issued:		FIXTURES AND FITTINGS at Cost, <i>less</i>	
525,000 Ordinary Shares of £1 each ..	525,000	Depreciation	11,000
SUNDRY CREDITORS	85,000	STOCK IN TRADE	30,000
PROFIT APPLICABLE TO THE UNEXPIRED		HIRE-PURCHASE DEBTORS, <i>less</i> Reserves	662,000
PORTION OF HIRE-PURCHASE CONTRACTS	131,000	CASH AT BANKERS AND IN HAND ..	12,000
PROFIT AND LOSS ACCOUNT	94,000		
	<u>£835,000</u>		<u>£835,000</u>

B. RETAILER, LTD.

BALANCE SHEET, 31ST DECEMBER 1929

	£		£
SHARE CAPITAL—		FREEHOLD PROPERTIES AT COST	140,000
Authorised and Issued:		FIXTURES AND FITTINGS at Cost, <i>less</i>	
675,000 Shares of £1 each, fully paid	675,000	Depreciation	20,000
SUNDRY CREDITORS	115,000	STOCK IN TRADE	65,000
GENERAL RESERVE, including Reserve for		SUNDRY DEBTORS, including Instalments	
Bad Debts	90,000	under Hire-Purchase Contracts ..	760,000
PROFIT AND LOSS ACCOUNT	120,000	CASH AT BANKERS AND IN HAND ..	15,000
	<u>£1,000,000</u>		<u>£1,000,000</u>

D. FINANCE CO., LTD.
BALANCE SHEET, 31ST DECEMBER 1929

£	£
SHARE CAPITAL—	
Authorised and Issued :	
250,000 Shares of £1 each, fully paid ..	250,000
GENERAL RESERVE	150,000
LOANS FROM BANKERS, secured per contra ..	1,000,000
DEPOSIT AND OTHER ACCOUNTS	500,000
REBATE OF INTEREST ON BILLS RECEIVABLE ..	65,000
PROFIT AND LOSS ACCOUNT	35,000
	<u>£2,000,000</u>
CASH AT BANKERS AND IN HAND	175,000
INVESTMENTS	50,000
BILLS RECEIVABLE	535,000
BILLS RECEIVABLE lodged as Collateral Security	1,200,000
LOANS AND OTHER ACCOUNTS	40,000
	<u>£2,000,000</u>

E. FINANCE CO., LTD.
BALANCE SHEET, 31ST DECEMBER 1929

£	£
SHARE CAPITAL—	
Authorised and Issued :	
250,000 Shares of £1 each, fully paid ..	250,000
BANK LOANS (secured)	550,000
SUNDRY CREDITORS	120,000
PROFIT AND LOSS ACCOUNT	80,000
	<u>£1,000,000</u>
CASH AT BANKERS AND IN HAND	1,000
HIREN'S' BALANCES (secured by Title to Vehicles)	875,000
SUNDRY DEBTORS ON LOAN ACCOUNT	60,000
INVESTMENTS	64,000
	<u>£1,000,000</u>

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ADDENDUM TO HIRE-PURCHASE ACCOUNTS AND FINANCE

By
CHAS. W. ASTON, A.C.A.

*Honours 1922 Final Examination Institute of
Chartered Accountants in England and Wales.*

LONDON:
GEE & CO. (PUBLISHERS) LTD.
6 KIRBY STREET, E.C.1
and 27-28 BASINGHALL STREET, E.C.2
1938

terms of the definition, then the agreements are to be treated for the purposes of the Act as a single agreement.⁴ It is interesting to compare the foregoing definition with that which appeared in the Bill, and which was in more popular language. It ran as follows :—

“ An agreement to hire goods under which the hirer is entitled, at his option, to buy the goods at the conclusion of the hiring, or under which the property in the goods is to pass to the hirer subject to the fulfilment by him of conditions prescribed in the agreement.”

A credit-sale agreement for the purpose of the Act is an agreement for the sale of goods under which the purchase price is payable by five or more instalments.⁵ It should be noted that nothing is said as to the period of the instalments, so that while an agreement for payment by six weekly instalments would fall within the scope of the Act, one for four quarterly instalments would not. Gas and electrical appliances are frequently sold on quarterly terms of payment, and credit-sale agreements for a period of only one year will not be affected by the Act.

With certain exceptions noted hereafter, the Act applies only to agreements made on or after 1st January 1939⁶ and does not extend to Scotland or Northern Ireland.⁷

The principal provisions of the Act are designed to ensure that—

1. The consumer shall know the cash price of the goods he is buying, and that every hire-purchase agreement shall contain a notice in the terms of the Schedule to the Act setting out (a) the conditions on which the hirer can determine the agreement

⁴—S.21

⁵—S.21

⁶—S.20(3) and 22 (2)

⁷—S.22 (3)

and (b) the restrictions on the owner's right to recover the goods.

2. In the case of a hire-purchase agreement he shall be able to determine the agreement provided he pays not more than *one-half* of the hire-purchase price.
3. If *one-third* of the hire-purchase price of goods has been paid, the owner shall not enforce any right to recover possession of the goods otherwise than by action in the County Court for the district in which the hirer resides or carries on business. On the hearing of any such action the Court has certain powers which are described more fully hereafter.
4. When a hirer, before he has paid off the whole of the instalments under an agreement, agrees to acquire further goods, the trader shall not be able to avoid the last foregoing provision of the Act by requiring the hirer to enter into a new agreement comprising both the old and the new goods.
5. On payment of one shilling the customer shall be entitled to receive a statement of the amount paid and remaining unpaid under the hire-purchase or credit-sale agreement.
6. Certain conditions and warranties such as apply to a sale of goods shall apply equally in the case of a hire-purchase agreement.
7. When a hirer is liable to make payments under two or more hire-purchase agreements, the trader shall not be permitted to appropriate payments to one of the agreements only.

Of principal interest in relation to the accountancy aspects of instalment trading are the requirement that the cash price of goods shall be stated, the right of a

hirer to return goods on paying not more than one-half of the hire-purchase price and the provisions affecting payments by a hirer who is liable under two or more hire-purchase agreements.

While there will continue to be cases to which the Act does not apply, the obligation to state the cash price means that, except in the case of credit-sale agreements under the value of £5, the cash price and hire-purchase price will usually be ascertainable, when there need be no difficulty in ascertaining what amount and rate of interest is charged for the extended payment facilities.

The right of a hirer to return goods on paying not more than one-half of the hire-purchase price may be a factor to be taken into account in certain cases when considering the reserve necessary for doubtful debts. Traders dealing in goods for which there is no ready second-hand market are likely to be principally affected. In such cases, payment of one-half of the hire-purchase price may do no more than cover the cost of the goods to the trader, and although there is a proviso that the hirer shall, if he has failed to take reasonable care of the goods, be liable for damage, depreciation due to fair wear and tear could not be recovered.

The provisions of the Act affecting payments by a hirer who is liable under two or more hire-purchase agreements will necessitate careful cross-referencing of all agreements with the same hirer, not only on the ledger accounts but also on the payment cards supplied to the hirer, since it will be necessary to ensure that cash is properly appropriated at the time of payment.

I.

Ignorance of customers as to the obligations they incur when entering into hire-purchase agreements should cease after the Act comes into operation. The requirements

as to giving information to customers are wide, and will apply not only to agreements entered into in shops but also to sales by house-to-house canvassers.

Before any hire-purchase agreement is entered into the owner has to state in writing to the prospective hirer, otherwise than in the note or memorandum of the agreement, the price at which the goods may be bought for cash. This requirement is sufficiently complied with, however, if when the hirer inspected the goods or similar goods they bore a label clearly stating the cash price, or if the hirer selected the goods from a catalogue, price list or advertisement which clearly stated the cash price.⁸

Moreover, a note or memorandum of the agreement must be made and signed by the hirer and by or on behalf of all other parties to the agreement and a copy delivered or sent to the hirer within seven days. This note or memorandum has to contain a statement of (a) the hire-purchase price ; (b) the cash price ; (c) the amount of each instalment ; (d) the due date or mode of determining the due date of each instalment ; and (e) the goods to which the agreement relates sufficient to identify them. The note or memorandum must also contain a notice, which is at least as prominent as the rest of the contents of the note or memorandum, in the terms set out in the Schedule to the Act.

The notice sets out in clear non-technical language the right of the hirer to terminate the agreement and the restriction of the owner's right to recover the goods, and is as follows:—

NOTICE

Right of Hirer to terminate Agreement

1. The hirer may put an end to this agreement by giving notice of termination in writing to any person who is entitled to collect or receive the hire-rent.

⁸—S.2 (1)

2. He must then pay any instalments which are in arrear at the time when he gives notice. If, when he has paid those instalments, the total amount which he has paid under the agreement is less than (*here insert the minimum amount which the hirer is required to pay in accordance with the provisions of sections four and nineteen of this Act*) he must also pay enough to make up that sum.

3. If the goods have been damaged owing to the hirer having failed to take reasonable care of them, the owner may sue him for the amount of the damage unless that amount can be agreed between the hirer and the owner.

4. The hirer should see whether this agreement contains provisions allowing him to put an end to the agreement on terms more favourable to him than those just mentioned. If it does, he may put an end to the agreement on those terms.

Restriction of Owner's right to recover Goods

1.* [*After (here insert an amount calculated in accordance with the provisions of Sections eleven and nineteen of this Act)* has been paid, then,] unless the hirer has himself put an end to the agreement, the owner of the goods cannot take them back from the hirer without the hirer's consent unless the owner obtains an order of the court.

2. If the owner applies to the Court for such an order, the Court may, if the Court thinks it just to do so, allow the hirer to keep either—

- (a) the whole of the goods, on condition that the hirer pays the balance of the price in the manner ordered by the Court; or
- (b) a fair proportion of the goods having regard to what the hirer has already paid.

* If the agreement is a "further" agreement within the meaning of Section fifteen of the Act (as to which, see page 236) the words in square brackets should be omitted.

Failure to comply with these various requirements will debar an owner of goods from enforcing the hire-purchase agreement or any contract of guarantee relating thereto or any right to recover the goods from the hirer, nor can he enforce any security given by the hirer or a guarantor. The Court may, however, subject to any

conditions it thinks fit to impose, give relief (except for failure to have a note or memorandum of the agreement signed by the hirer and by or on behalf of all other parties to the agreement) on being satisfied that it would be just and equitable and that failure to observe the requirements of the Act has not prejudiced the hirer.⁹

Similar provisions as to stating the cash price and as to a note or memorandum of the agreement apply in the case of credit-sale agreements where the total purchase price exceeds £5, except that

- (a) The notice in terms of the Schedule to the Act does not have to be incorporated in the agreement, for the reason that it is inapplicable.
- (b) Failure to comply with the requirements of the Act will only debar an owner from enforcing his rights in cases where the total purchase price under the credit-sale agreement exceeds £5.¹⁰

II.

The second main provision of the Act gives customers a right to end a hire-purchase agreement on certain statutory terms. At any time before the *final payment* under a hire-purchase agreement *falls due*, the hirer may determine the agreement by giving written notice to any person entitled or authorised to receive the instalments. There is, of course, no similar provision in the case of a credit-sale agreement, which, being an outright sale, cannot be cancelled any more than can a sale on ordinary credit terms. On giving notice to terminate, the hirer is to be liable to pay any instalments then in arrear, together with any sum necessary to make the total payments under the agreement equal to *one-half* of the hire-purchase price or such less sum as may be specified

in the agreement.¹¹ For this purpose any installation charges stated separately in the agreement are not to be reckoned as part of the hire-purchase price but are to be paid in addition. Installation charges include the cost of installing electricity, gas or water, fixing the goods to the premises where they are to be used, altering premises to enable the goods to be used thereon, or constructing or erecting the goods on the premises.¹²

It may be noted in passing that the creation of a hirer's right to terminate an agreement, unlike the restrictions on an owner's right to terminate, operates only in the case of agreements entered into after 1st January 1939. A hirer may have a right to determine the hire-purchase agreement by virtue of the terms of the agreement itself, quite apart from the right created in the Act, and any such right is not in any way affected by the provisions of the Act.¹³ A clause in the agreement purporting to take away from the hirer his statutory right to determine the agreement, or purporting to increase the statutory liability of the hirer on termination of the agreement by him under the Act, is null and void.¹⁴ The agreement may, however, as stated above, specify a sum payable on termination *less* than the statutory liability.

The exercise by a hirer of his statutory right to determine a hire-purchase agreement does not enable him to avoid liability for damages for failure to take reasonable care of the goods.¹⁵

III.

Having given hirers a statutory right to terminate hire-purchase agreements, the Act then turns to re-possession of goods by traders.

¹¹—S.4(1) ¹²—S.19 ¹³—S.4(4) ¹⁴—S.5(b) ¹⁵—S.4(2)

It has been seen that a hirer may return any goods which he has been acquiring under a hire-purchase agreement on paying not more than *one-half* of the total price. When *one-third* of the hire-purchase price has been paid or tendered, the owner may not, after the commencement of the Act (whether the agreement was made before or after 1st January 1939¹⁶) recover possession of the goods from the hirer otherwise than by action, unless the hirer has himself terminated the agreement. If the owner acts in contravention of this provision of the Act, the hirer is released from all liability under the agreement. Furthermore, the hirer and any guarantor may recover from the owner in an action for money had and received all sums paid or security given under the agreement or contract of guarantee.¹⁷

When calculating whether one-third of the hire-purchase price has been paid, any installation charges stated separately in the agreement are not to be reckoned as part of the hire-purchase price but are to be paid in addition.¹⁸ In the case of agreements entered into before the commencement of the Act, it is more than likely that the installation charges (if any) would not have been stated separately, in which case the owner may serve on the hirer a notice specifying a sum not exceeding the actual expenses incurred.¹⁹ To be effective, the notice has to be served at least 28 days before action is commenced, and traders would therefore be well advised to serve notice in all cases as soon as possible after 1st January 1939, and meanwhile to see that new agreements entered into in 1938 specify the installation charges (if any).

If an owner wishes to bring an action to recover possession of goods in respect of which one-third of the

¹⁶—S.20(1)(b)

¹⁷—S.11

¹⁸—S.19

¹⁹—S.20(2)

hire-purchase price has been paid or tendered, he must after 1st January 1939 (whether the agreement was made before or after the commencement of the Act²⁰), do so in the County Court for the district in which the hirer resides or carries on business²¹. Thus will be removed a source of complaint that traders brought such actions in a Court remote from the district where the hirer resided, sometimes making it impossible for him to attend. So far as traders are concerned, they are likely to find their legal expenses will be heavier, as they will have to be represented at various Courts instead of only at their local Court.

On hearing of an action by the owner for recovery of the goods the Court may (*inter alia*)²²—

- (a) Make an order for the goods to be delivered to the owner.
- (b) Postpone the operation of the order on condition that the hirer or a guarantor pays the unpaid balance of the hire-purchase price in such instalments as the Court thinks just. (See below as to the liability of the goods to be seized under a distress or in bankruptcy).
- (c) Order part of the goods to be delivered to the owner and as regards the remainder order that part to be transferred to the hirer, provided the amount paid by the hirer exceeds the price of the remainder by at least one-third of the unpaid balance of the hire-purchase price.²³

Recovery of goods by action in Court is bound to occupy more time than the old method of going to the premises where the goods were to be found and removing them to the owner's premises. During the interval while the action is pending the hirer would be able to continue

²⁰—S.20(1)(c)

²¹—S.12(1)

²²—S.12(4)

²³—S.12(6)

using the goods and perhaps cause them to depreciate, and accordingly the owner may apply to the Court for an order restricting or prohibiting the user of the goods or otherwise as the Court thinks just for the purpose of protecting the goods.²⁴

A further necessary protection for the owner is to be found in a modification of the liability of goods to be seized under a distress.

The law as it existed prior to the Act of 1938 is summarised on page 35. Hitherto, if an event occurred entitling an owner to terminate an agreement and he did so, he could give notice of his interest to the landlord of the premises where the goods were situate and the goods were then protected from distress. After the commencement of the Hire-Purchase Act, 1938, and provided one-third of the hire-purchase price has been paid, the owner would be obliged to proceed by way of action against the hirer. Pending the hearing of the action the owner would not be able to terminate the agreement and consequently could not protect the goods from distress.

Accordingly, the Act now provides that where an owner, being entitled to recover goods which have been let under a hire-purchase agreement, has commenced an action to enforce that right, the goods shall not thereafter be treated as goods comprised in the hire-purchase agreement for the purpose of Section 4 of the Law of Distress Amendment Act, 1908.²⁵

Furthermore, if the Court has postponed the operation of an order for the return of goods to any person (as described above), the goods shall not, during the postponement, be treated as goods which are by the consent or permission of that person in the possession, order, or

²⁴—S.12(3) ²⁵—S.16(2)

disposition of the hirer for the purpose of Section 4 of the Law of Distress Amendment Act, 1908, or of Section 38 of the Bankruptcy Act, 1914.²⁶

The remarks on pages 35 to 37 under the headings "Distress" and "Bankruptcy" will require to be read in conjunction with the foregoing provisions of the Hire-Purchase Act, 1938.

IV.

When a customer is approaching the time when he has practically completed paying the instalments under a hire-purchase agreement, it is not unusual for him to look around for additional articles to acquire, and when he calls on the trader to pay an instalment he may select further goods that he wishes to buy on hire-purchase terms. The trader may then persuade the hirer to include the whole of the goods, both old and new, in one document so that he pays only a single periodical instalment instead of two. Such a course may seem to the hirer to be quite a good idea, but actually it is to his detriment, since, on failure to keep up the instalments, the whole of the goods could be recovered even though he may by then have paid in total more than the value of the old goods. The evils resulting from such practices should be largely avoided in future because if the second agreement is entered into after one-third of the hire-purchase price payable under the first agreement has been paid or tendered, then whether one-third of the hire-purchase price payable under the second agreement has been paid or not, the owner cannot recover the goods without bringing an action in Court.²⁷ The second agreement is known as a "further" agreement.

Cases also arise where a customer has paid more than

²⁶—S.16(1)

²⁷—S.15

one-third of the hire-purchase price payable under an agreement and then wishes to enter into a new arrangement for settling the outstanding balance. If in such an event a new agreement is entered into, the owner is obliged, as from the commencement of the second agreement, to bring an action in Court if he wishes to recover the goods.²⁸

V.

The next provision of the Act to be considered applies both to hire-purchase and credit-sale contracts and entitles the customer at any time before the final payment has been made, to obtain from the trader (or any other person entitled to enforce the agreement against him), at a cost of one shilling, a copy of the agreement, together with a signed statement showing :—

- (a) the amount paid under the agreement ;
- (b) the amount due but unpaid with the due date and amount of each unpaid instalment ;
- (c) the amount of any further instalments payable in the future and the date or mode of determining the date upon which they become payable.

These particulars have to be delivered within four days of receipt of a written request, failing which, then, so long as default continues, the trader is debarred from enforcing the agreement or any guarantee given in connection therewith, or (in the case of a hire-purchase agreement) recovering the goods, and if default continues for a month, a fine not exceeding £10 may be imposed on summary conviction.²⁹

VI.

Until the passing of the Hire-Purchase Act, 1938, hire-purchase agreements had obtained practically no statu-

²⁸—S.15

²⁹—S.6

tory recognition. It should be unnecessary to stress the fact that they do not constitute contracts of sale and that they are consequently not within the scope of the Sale of Goods Act, 1893. One result of this position has been that hitherto no conditions or warranties could be imported into an agreement except those set out in the Memorandum of Agreement.

The position of hire-purchase agreements is, now brought into line with contracts for the sale of goods in the following respects. In every hire-purchase agreement there shall be implied warranties that the hirer shall have and enjoy quiet possession of the goods and that they shall be free from any charge or encumbrance in favour of any third party at the time when the property is to pass. There shall also be implied conditions on the part of the owner that he shall have a right to sell the goods at the time when the property is to pass and that they are of merchantable quality. The implied condition as to quality is not to apply, however, in the case of second-hand goods stated in the agreement to be such, nor does the condition extend to defects of which the owner could not have been aware or which should have been apparent to the customer.³⁰

These warranties and conditions cannot be excluded, notwithstanding any agreement to the contrary.³¹

If the hirer expressly or by implication makes known the particular purpose for which the goods are required, there shall be an implied condition that the goods are reasonably fit for such purpose.³²

This condition can only be excluded if there is a provision to that effect in the agreement, the meaning of which is made clear to the hirer before the agreement is signed.³³

³⁰—S.8(1)

³¹—S.8(3)

³²—S.8(2)

³³—S.8(3)

VII.

Payments made by a hirer who is liable under two or more hire-purchase agreements with the same owner and who does not specify to which one his payments are to be allocated, have now to be considered. In such cases it may hitherto have been open to a trader to appropriate the payments as he wished. Assume, for example, that a hirer had entered into two agreements, the one covering china and glass and the other furniture, and that he paid various sums without earmarking them to either agreement. The trader could credit all moneys received from the hirer to the first agreement, being the one covering the goods with the lesser second-hand value, and then take steps to recover the furniture on the ground that the instalments were in arrear. Such a practice would be manifestly inequitable and after the commencement of the Act will become illegal.

A hirer who is liable under two or more hire-purchase agreements with the same owner will be able, notwithstanding any agreement to the contrary, on making a payment to appropriate it towards any one or more of the agreements in such proportions as he desires. If he fails to make such appropriation, the payment has to be appropriated towards satisfaction of the sums *due* under the respective hire-purchase agreements in the proportions which those sums bear to one another.³⁴ This provision of the Act will apply to all payments made after 1st January 1939 even though they may be in respect of agreements entered into before that date.³⁵

It should be noted that the apportionment is to be on the basis of the total sums *due* under each agreement at the time a payment is made.

There are no corresponding provisions applicable to

³⁴—S.9

³⁵—S.20(1)(a)

credit-sale agreements, and it will be observed that apportionment has only to be effected in the case of payments under two or more hire-purchase agreements. Nothing is said in the Act as to the procedure in a case where a customer, having entered into a hire-purchase and a credit-sale agreement, makes a payment without specifying to which agreement the amount is to be allocated.

In connection with the foregoing provision, it should be remarked that many rulings for hire-purchase ledgers are not designed to show at a glance the total amount of instalments due, but unpaid on an account. It may be found desirable to modify the rulings accordingly, but on the other hand, if customers can be persuaded to appropriate at the time of payment, existing rulings may be found adequate.

It will be seen that there is nothing in the Hire-Purchase Act, 1938, that has any effect on the accountancy principles enunciated in this book. As already stated, the sections of most interest to accountants are those under which (a) the cash price has to be stated; (b) the hirer can return goods on paying not more than one-half of the hire-purchase price, and (c) payments by a hirer may in certain circumstances have to be apportioned between two or more agreements. While much will depend upon the future policy adopted by traders, it seems possible that the cost of conducting instalment trading will be increased on account of higher bad debts, legal expenses and bookkeeping and general supervision costs.

THE FOLLOWING ALTERATIONS MAY BE MADE IN THE BODY OF THE BOOK :

Page 23. If a definition of a hire-purchase agreement is required, that given in the Act (page 225) should be quoted rather than that suggested on page 23.

Pages 24 and 31. Deferred payment and extended payment agreements are now referred to in the Act as credit-sale agreements.

Page 26. The agreement must state the cash price of the goods as well as the hire-purchase price.

Page 28. Clause 9. The hirer cannot be required to pay more than one-half of the hire-purchase price if he returns the goods.

Page 29. The agreement must contain a notice in terms of the Schedule to the Act (page 229).

Pages 35-37. The notes on the position of goods in a distress or bankruptcy should be read in conjunction with the provisions of Section 16 of the Act (page 235).